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IN THE

Supreme Court of the United States

October Term, 1978

No. 78-182

O. E. SERWOLD and HELEN SERWOLD, his wife,
Defendants-Petitioners,

v.

KENNETH N. NELSON,
Plaintiff-Respondent.

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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CITATION TO OPINIONS BELOW

The opinions of the Honorable James M. Burns, District Court Judge, sitting by designation in the Western District of Washington, consisting of two letter opinions and the transcript of an oral decision, followed by formal written findings and conclusions, finding defendants liable to plaintiff for damages under S.E.C. Rule 10b-5 are all printed in the Appendix. The findings and conclusions were entered on September 26, 1975. Final judgment was entered on September 29, 1975 (Appendix, p. 22). The district court's opinions were not reported. The opinion of the court of appeals, which affirmed the finding of liability but reversed and remanded for an increased award of damages, was filed on April 3, 1978. The court of appeals opinion has not yet been reported officially but the full text is reported

unofficially as *Nelson v. Serwold,* [current] CCH Fed. Sec. L. Rep. ¶96,399 (1978). The court of appeals opinion is reproduced in the Appendix at pp. 23-37. Defendants' Petition for Rehearing En Banc was rejected on June 26, 1978 (Appendix, p. 38).

JURISDICTION

The jurisdiction of this Court is invoked under 28 U.S.C. §1254(1).

ISSUES PRESENTED

This case involves a civil claim by a seller of securities against purchasers under Section 10(b) of the Securities and Exchange Act of 1934 and Rule 10b-5. The issues presented by this petition are:

1. May a court of appeals base 10b-5 liability on its own *de novo* findings that the defendants' conduct was "reckless" or "knowing", where the trial judge had found a technical violation but had also expressly found that the defendants acted without "scienter" and that their conduct was neither "deliberate" nor "knowing"?

2. In light of this Court's decision in *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976), which was issued while the instant case was on appeal, may 10b-5 liability be imposed for "reckless" conduct, particularly where as here the trial judge has expressly found that defendants' conduct was neither "deliberate" nor "knowing"?

3. Should 10b-5 liability be imposed for "reckless" conduct and if so, what sort of conduct should be defined as reckless?

4. Did the federal district judge abuse his equitable discretion (as held by the court of appeals) in fixing the seller's damages as the increase in the value of the shares

over a reasonable time period following the sale, where he considered (1) the lack of scienter of defendants, (2) the significance of defendants' personal efforts in creating the increase in value of shares after their acquisition, (3) the passage of six and one-half years between the acquisition of the stock and the realization of a substantial paper profit on its exchange for shares in another corporation, and (4) the likelihood that with diligence the sellers could have discovered the information they claimed went undisclosed at the time of sale?

STATEMENT OF THE CASE

Parties

Poulsbo Rural Telephone Association ("PRTA"), a Washington corporation, was formed in 1908 to provide telephone service to a rural area surrounding the Town of Poulsbo, located in Northern Kitsap County, Washington (FF. 5; R. 357).[1] Petitioner-Defendant O. E. Serwold ("Serwold") was first employed by PRTA in the 1930's as a lineman (Tr. 0011). In 1957 Serwold became the company's president. Respondent-Plaintiff Kenneth N. Nelson was one of the heirs to an estate probated in Wisconsin in which a certificate evidencing ownership by one "R. Norman" of 36 shares of PRTA stock was discovered in 1962.

Background

As late as the mid 1950's, PRTA was still operating with old style, handcrank, magneto telephones (Tr. 0030). Even

1. Documents filed in the clerk's office below comprise the first two volumes of the record and are designated with the prefix "R". Where a particular Finding of Fact is referred to, it is preceded by the letters "FF". References to live testimony are designated by the prefix "Tr." followed by the page references. The Korth deposition is referred to by using the designation "Korth Dep. p. . .".

after his assumption of the presidency, Serwold was still "out working with the crew and hanging wire and putting in telephones" (Tr. 0020). Desiring to modernize PRTA's equipment and install a dial system, Serwold applied for a sizable loan from the Pacific Mutual Life Insurance Company in the mid-1950's. He was advised by the company's then attorney that he should obtain "control" of PRTA so that he could effectively deal on its behalf with the proposed lender (Tr. 0030).

In 1956 Serwold embarked on a program of offering to pay $8.00 per share for PRTA stock. Because he did not personally have sufficient funds to acquire enough stock at that price to obtain the control counsel had recommended, he discussed the matter with three friends, Rudie Iversen, William H. Gee, and J. Paul Coie, a Seattle attorney, who had occasionally done work for Serwold (Tr. 0042).

The four friends agreed orally that Serwold and Iversen, each of whom already owned stock in the company, would put their shares into a common pot, that the four would contribute funds sufficient to acquire a controlling amount of stock, that the stock so contributed or acquired would be held in the name of Serwold (who was about to become the president of PRTA), and that the four would have beneficial interest in the stock so held in the ratio of 30% for Serwold, 30% for Iversen, 30% for Gee, and 10% for Coie (Tr. 0046).

By 1959 the group had acquired 56% of PRTA's stock (Tr. 0030). Serwold thereafter discontinued his active efforts to acquire PRTA stock (Tr. 0030-31). The fund which had been used to acquire the shares was exhausted (Tr. 0099). While Serwold occasionally acquired additional small amounts of stock in the years 1959 through 1971 (Tr. 0031-37, 0098), these were acquired only when shareholders came to him and asked if he would buy their holdings. Such small lots of shares were not acquired with group funds, or as part of the agreement to acquire control (Tr. 0099-100). Only in 1971, when the matter of sale of all corporate assets was being considered, did the other group members learn that Serwold, out of a sense of loyalty to the three friends who had assisted him in the earlier days of PRTA, planned to treat these few shares in common with those acquired pursuant to the earlier agreement (FF. 23; R. 363; see Tr. 0050, 0099-100).

Serwold's only objective shown by the evidence in acquiring control of PRTA was "to try and build a telephone exchange" (Tr. 0030). He was not asked about any long-standing plan to sell the company and the record is devoid of any evidence that he had formed any such intention prior to late 1968 or 1969. (Tr. 0106). The only other evidence in the record as to the purposes of the persons who jointly agreed to assist Serwold acquire control came during the examination of Coie who testified that he envisioned that "in the dim future" PRTA "ought to have some intrinsic value" (Tr. 0047-49).

The evidence showed that the first unsolicited "feelers" received by Serwold as president of PRTA from persons interested in purchasing all or part of the company's assets or stock came in 1965 or 1966 (Tr. 0106-07). At that time Serwold was approached by ". . . a stock manipulator from Chicago who wanted to buy control" (Tr. 0106). Serwold rejected this proposal out of hand (Tr. 0107). The first real discussions about possible sale of the company occurred in late 1968 or 1969 between Serwold and a

representative of a company called Telephone Utilities located in Ilwaco, Washington (Tr. 0106).

In January, 1972 PRTA sold its assets to United Utilities Incorporated (now United Telecommunications, Inc.). The discussions which led to the sale commenced in December, 1970 (Tr. 0100). Under the Agreement and Plan of Reorganization, PRTA exchanged its assets for United stock which PRTA, in turn, distributed to its shareholders. Based on the paper value of United stock, a share of PRTA had become worth about $500 by the time of the sale to United.

The Sale Here Involved

The transaction which gives rise to this litigation began in October, 1962 and was consummated on September 16, 1965, when the 36 shares of PRTA stock which had been held by the Wisconsin estate were sold to Serwold. The negotiations which led to the 1965 sale were conducted entirely by correspondence between Earl A. Korth, a Wisconsin attorney who was selling the stock for the heirs (including plaintiff) of a man named Nels Nelson, and by J. Paul Coie, Serwold's friend and personal attorney. At the time when this letter was sent PRTA had 7,123 shares outstanding. More than 50% were held in the name of Serwold (Appendix p. 13).

By a letter addressed to PRTA and dated October 17, 1962, Korth inquired concerning the status of a stock certificate found in the papers of the decedent Nelson showing the owner to be "R. Norman". Korth's letter asked for information as to "the status of this stock" and specifically asked that his request for such information be transmitted "to any source that may be able to give it to us . . ." (R. 24; Ex. A).

On receipt of Korth's letter Serwold asked Coie to respond because it came from an attorney (Tr. 0019), and because PRTA then had no lawyer who was regularly handling such matters (Tr. 0020).

Coie made inquiry of the corporate secretary concerning the "status" of the stock (Tr. 0042-43, 0053). He learned that the corporate records still listed "R. Norman" as a stockholder. Because the "R. Norman" listed on the corporate records and on the face of the stock certificate was plainly not the Nels Nelson in whose estate the certificate was found, Serwold suggested to Coie that an offer of $5.00 per share be made due to the "risk of clouded title" (Tr. 0057). On December 11, 1962, Coie responded to Korth, stating that the stock still was shown by the corporate records as owned by "R. Norman" and, as directed, making the offer of $5.00 per share (R. 25; Ex. B).

Korth replied on January 22, 1963 (R. 26-27; Ex. C), stating that "in view of the amount involved we feel it would not justify any extensive administration proceedings", but setting forth what he conceived to be the chain of heirship which indicated that the decedent on whose behalf he was acting was the owner of the shares in question. Korth's concluding sentence stated: "I wish you would also advise us concerning any dividends that are accrued." Coie did not reply to that letter until April 15, 1965 (R. 28; Ex. D), when he renewed the offer on behalf of Serwold to pay the sum of $180.00 or $5.00 a share for the 36 shares and answering the question about dividends as follows:

> Dear Mr. Korth:
>
> It has been some time since we last corresponded. In your letter of January 22, 1963 it was most unclear as to who presently owns the stock. If you will give

us an affidavit and surrender Certificate #305 for 36 shares of stock of the Poulsbo Rural Telephone Association, the enclosed check of O. E. Serwold, payable to Herb Nillsson, Administrator of the Estate of Nels Nelson, in the sum of $180.00 may be cashed.

There have been no dividends ever declared since the formation of this company, and none can be anticipated for years because of mortgage commitments required to finance capital improvements. This is a regulated utility and there has never been a surplus from which dividends could have been declared.

Very truly yours,
/s/ J. Paul Coie
J. Paul Coie

JPC:ho
Enclosure
cc: Mr. O. E. Serwold

On April 20, 1965, Korth wrote to Herbert Nillsson (one of the heirs who was plaintiff's brother) informing him of the above (R. 29; Ex. E). A copy was sent to Coie but the record is silent as to whether Coie forwarded the letter to or showed the letter to Serwold.

The Korth letter referred to the $180.00 offer, saying "We assume it represents the fair market value of the stock". At about that time the book value was about $60.00 per share, calculated by dividing the stockholders' equity by the number of outstanding shares. However, Mr. Coie had no familiarity with the company's financial statements at that time and had no knowledge concerning the market value of the shares (Tr. 0056).[2] Judge Burns, who relied in making his findings "to a considerable extent upon my observation and demeanor and manner of the witnesses when they testified" (Appendix p. 20), observed in his oral opinion, ". . . Coie and Korth, from all that appears, were simply two lawyers, one in Wisconsin and one in Washington, carrying on what was apparently a routine and rather minimal transaction—not at all unusual in the probating of estates of people of the age of the decedent" (Appendix p. 3-4).[3]

2. Nor would Coie have been enlightened as to "market value" if he had examined the financial statements, of which Exhibits Q, R, S and T are typical, since such value is not shown there and could not be calculated from the information set forth, since the number of outstanding shares is not shown.

Herbert Nillsson discussed the $180.00 offer with the plaintiff, his brother, on the telephone (Tr. 0076-79). The plaintiff testified that the heirs felt that the $180.00 was insufficient:

THE COURT: Mr. Cameron, excuse me a minute. Mr. Nelson, in 1965, did your brother ever talk to you about this $180.00 offer?

A. On the telephone, yes.

Q. Was there some suggestion in the conversation that that wasn't enough?

A. Well, I don't think any of us were ever satisfied. It just seemed like a small amount, really. No basis for it.

Q. I didn't mean to interrupt you. Were you complete with your answer?

A. I was just going to say we had no basis or way of knowing what it was worth. We thought that wasn't very much.

Tr. 0079.

Herbert Nillsson wrote to a cousin living in the Seattle area inquiring about PRTA (Tr. 0067-68). The cousin made inquiry of other relatives, but none of the relatives

3. The transaction was routine and minimal both in the amount of money involved, $250.00, and in the percentage of PRTA stock involved, about one two hundredths of the outstanding shares.

checked directly with the telephone company, nor made any inquiry with any agency of Washington State (Tr. 0069), even though Coie's April 15 letter had stated that PRTA was a regulated utility. Korth at no time requested any financial information concerning PRTA from Coie, beyond his query about accrued dividends.

On July 9, 1965, Korth replied (R. 30-31; Ex. F) to Coie's offer of $180.00, stating that he had conferred with the heirs and that the offer was "not sufficient". Rather than inquiring further about PRTA, Korth stated that ". . . . because no dividends have been received and it is a considerable distance from the residence of the parties . . ." he was proposing the sum of "$250.00 for the stock". On July 14, 1965, Coie accepted that proposal on behalf of Serwold (R. 32; Ex. FF 1). Korth then forwarded the certificate for the 36 shares to Coie (R. 36; Ex. H). At no point during the negotiations for the sale did Coie and Korth have any face-to-face dealings; nor did they converse on the telephone (Tr. 0057; Korth Dep. p. 23).

The 36 shares were paid for by Serwold out of his own funds and no financial assistance was solicited or received from those who had earlier contributed funds toward the acquisition of control (Tr. 0099-100). Although plaintiff contended in the courts below that Coie knew he would receive 10% of the 36 shares being purchased the record is devoid of any evidence that Coie had any expectation in the 1962-65 period that he would have any such beneficial interest. Only in 1971 did Coie learn of Serwold's intention to treat all shares which were then held in his name (including the later acquired shares purchased with his own funds) as within the 1956 informal oral agreement (Tr. 0050).

In weighing the evidence discussed above Judge Burns repeatedly commented on the absence of any degree of scienter as follows:

1. In his opinion of October 25, 1974 (R. 314; Appendix p. 6):

> *I certainly cannot say from the evidence that the non-disclosure* which I have now found to be omissions prohibited by 10b-5 *occurred knowingly in the "scienter" sense.*
>
> I do not believe that the evidence justifies a finding that either Mr. Serwold, or particularly Mr. Coie, deliberately and cold-bloodedly set out to conceal information which 10b-5 requires to be provided. This is particularly true with a small block of stock, which, after all—even in 1965—had the book value of only about $1,800. In this I rely to a considerable extent upon my observation of the demeanor and manner of the witnesses when they testified before me. Consequently, *this lack of scienter* would tend to militate against the stricter rule of *Myzel*, which calls for complete disgorgement by persons who deliberately set out to cheat. Rather, *the lack of scienter* would tend to call for a lesser measure of damages—perhaps the difference between price and market, or perhaps a formula which would achieve a higher figure, but one still below the *Myzel* measure.

(Emphasis supplied)

2. In his letter opinion of December 5, 1974 to counsel:

> As stated in my earlier opinion *I do not believe that the evidence justifies a finding that either Mr. Serwold or Mr. Coie willfully and deliberately set out to conceal information which §10b-5 requires.*

(Emphasis supplied) (R. 351; Appendix p. 8)

3. In the same letter:

> Despite *the lack of deliberate and willful fraud in* this case, the defendants' conduct does constitute a violation of the Securities law and of plaintiff's rights.

(Emphasis supplied) (R. 352; Appendix p. 9)

4. In the formal findings which he himself prepared:

> There was no evidence to justify a finding that either Mr. Serwold, or particularly Mr. Coie, deliberately and cold-bloodedly set out to conceal information which 10b-5 requires to be provided. This is particularly true with a small block of stock which, after all—even in 1965—had the book value of only about $1,800. *In this the court relies to a considerable extent upon observation of the demeanor and manner of the witnesses when they testified.*

(Emphasis supplied) (R. 366; Appendix p. 20)

5. In his first conclusion of law:

> The *lack of scienter* militates against the stricter rule of *Myzel v. Fields*, 386 F.2d 718, which calls for complete disgorgement by persons who deliberately set out to cheat. Rather, the *lack of scienter* calls for a lesser measure of damages—more than the difference between price and market, but one still below the *Myzel* measure.

(Emphasis supplied) (R. 366; Appendix p. 20)

REASONS FOR GRANTING WRIT

Introduction

If allowed to stand the decision below will:

1. *Seriously aggravate the present confusion as to the application of* Hochfelder *in cases where scienter and wilfullness are lacking.*

The public interest in enunciation of clear criteria for imposition of 10b-5 liability cannot be overstated. The volume of print devoted to analysis of *Hochfelder* by legal scholars and judges attests to the crucial importance of clear judicial definition of the responsibilities of sellers of securities. The instant case, which presents an unusually unambiguous record and equally unambiguous findings

by the trial judge, provides an ideal vehicle for clarification of current uncertainties in a significant and active field of the law.

2. *Extend and expand the concept of materiality in Rule 10b-5 cases to unprecedented limits, not contemplated or intended by the authors of the rule.*

The facts that a group of men held controlling interest in PRTA and at least one hoped it would prosper enough so that some day "in the dim future" the company might be sold profitably could hardly qualify as facts which would influence the heirs of an estate which held a few shares. Indeed, in many, if not most, companies, some group of stockholders has control, hopes the company will make money and hopes that some day the value of their holdings will increase. The superficial consideration of this issue by the court of appeals is demonstrated by its failure even to discuss this Court's recent reformulation of the definition of materiality in *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976). That reformulation strongly supports petitioners' position here.

3. *Provide a glaring example of adoption of de novo findings by a Court of Appeals fundamentally at odds with those entered by the trier of fact, based on the demeanor of the witnesses.*

The trial judge found that the defendants acted without "scienter" and that their conduct was neither "deliberate" nor "knowing". Further the trial court did not find that the defendants acted either negligently or recklessly. Yet the court of appeals predicated its decision on a finding of recklessness, without either remanding the case to Judge Burns for further review in light of the issuance, while the

case was on appeal, of *Hochfelder*, or determining that Judge Burns' findings were "clearly erroneous" under F.R.C.P. 52(a).

4. *Allow to stand the court of appeals' "draconian"[4] judgment that defendants are liable for a "full disgorgement of appreciation in value" instead of the far less drastic measure adopted by the trial judge.*

In its opinion letter of December 5, 1974 (Appendix pp. 8-10) the trial court discussed in detail its reasoning on damages. Because the court found that defendants had committed a technical but nonwillful violation of 10b-5, it imposed a modest measure of damages. Despite the fact that the matter of damages is peculiarly one within the sound discretion of the trier of the facts, the court of appeals adopted a measure of damages seldom applied even to punish the grossest fraud. Judge Burns in his letter opinion, observed, "No decision of which I am aware has required a defendant to disgorge profits earned more than two years after the original transfer" (Appendix p. 8). The court of appeals judgment would require disgorgement of profits earned between 1965, the time of the sale in question, and 1971, when PRTA was sold to United Utilities.

In support of this petition we shall address, in order, each of the four points made above.

1. *The Court of Appeals Conclusion That the Conduct in Question Was Reckless Is Contradicted by the Facts Found by the Trial Judge*

In *Hochfelder, supra,* this Court reserved for future consideration the question whether, in some circumstances,

4. Chief Judge Friendly so characterized this extreme type of remedy in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281, 1306 (2nd Cir. 1973).

reckless behavior might support a claim of liability under Section 10(b) and Rule 10b-5.

In support of its conclusion that the conduct of the defendants was "reckless" the court of appeals stated (Appendix, p. 32):

> The district court had sufficient evidence to find liability. It appears that the defendants' omissions were, at the very least, with knowledge. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2nd Cir. 1973). They knew of the control group, the outstanding but still indefinite plans to sell after construction and improvement had conferred added value, and the steady and significant increases in earnings and book value in the few years between the seller's first inquiry and the ultimate sale of the 36 shares.

We submit that the court of appeals has confused knowledge of undisclosed facts (*i.e.* the existence of a "control group" and its long range hopes which we believe were mistakenly determined to be material) with intentional misconduct. Although this Court in the *Hochfelder* opinion used the phrase "knowing" or "knowingly" at several places, in each instance the term was used in association with such terms as "intentional", 425 U.S. 197, 198, 207, "intentionally", 425 U.S. 198 and "willful . . . . or purposeful", 425 U.S. 207. In each such instance the word "knowing" or "knowingly" is used to modify words such as "misconduct", "practices", or "conduct". The Court clearly appeared to have referred, not to mere knowledge of facts which may have been omitted, but to some degree of consciousness on the part of the defendant that the plaintiff was being misled to his detriment by the omission.

The trial court clearly found that the nondisclosure which gave rise to liability did not occur "knowingly in the

'scienter' sense" (Appendix p. 6; R. 311-12). In light of the cases which have discussed the meaning of "recklessness" since this Court left that subject open for further elaboration in *Hochfelder,* the above determination by the trial court resolves conclusively the question whether the defendants were guilty of "recklessness".

In *Franke v. Midwestern Oklahoma Development Authority,* 428 F. Supp. 719, 725 (W.D.Okl. 1976) Judge Bohanon said:

> Plaintiff attempts to persuade that "recklessness" is a substitute for scienter. In the context of an omissions case, reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it. *See Beecher v. Able,* CCH Fed. Sec. L. Rep. para. 95,303 (S.D.N.Y. 1975); Prosser, Law of Torts, 185-186 (4th ed. 1971); *Ernst & Ernst v. Hochfelder, supra,* 425 U.S. 185, at 190, . . . fn. 5.

In *Sundstrand Corp. v. Sun Chemical Corp.,* 553 F.2d 1033, 1039-40, 1044-45 (7th Cir. 1977) the court at 1045 elaborated on the *Franke* test quoted above, saying:

> The *Franke* definition of recklessness is "the kind of recklessness that is equivalent to willful fraud". *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 868 (2d Cir. 1968) (Friendly, J., concurring) . . . .
>
> Indeed, the *Franke* definition of recklessness should be viewed as the functional equivalent of intent. Cf. Bucklo[,] *Scienter and Rule 10b-5,* 67 NW.U.L.Rev. 562, 570-571 (1972). Under this definition, [1] the danger of misleading buyers must be actually known or so obvious than any reasonable man would be legally bound as knowing, and [2] the omission must derive from something more egregious than even

> "white heart/empty head" good faith. While this definition might not be the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent for intent, because it measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission. [bracketed numbers added.]

The *Sundstrand* opinion says further with reference to conscious culpability:

> This is a subjective test with the requirement of something more than "inexcusable negligence" imposed because of *Hochfelder,* 425 U.S. at 190 n.5 . . . . Thus if a trial judge found, for example, that a defendant genuinely forgot to disclose information or that it never came to mind, etc., this prong of the *Franke* test would defeat a finding of recklessness even though the proverbial "reasonable man" would never have forgotten.

Id., n.20.

In *Sanders v. John Nuveen & Co., Inc.,* 554 F.2d 790, 792-93 (7th Cir. 1977) after remand by this Court, the court of appeals carefully considered the evidence adduced in the lower court in light of this Court's pronouncement in *Hochfelder.* In holding that the conduct in question did not rise to the level of "reckless behavior" the court said (p. 793):

> In view of the Supreme Court's analysis in *Hochfelder* of the statutory scheme of implied private remedies and express remedies, the definition of "reckless behavior" should not be a liberal one lest any discernible distinction between "scienter" and "negligence" be obliterated for these purposes. We believe "reckless" in these circumstances comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence.

In *Felts v. National Account Systems Ass'n., Inc.*, 446 F. Supp. 357, 360 (N.D.Miss. 1977) the district court in considering the meaning of "recklessness" stated that the *Hochfelder* rule meant that liability under Rule 10b-5 could not be grounded on something less than an

> injury resulting from a conscious deception or from a misrepresentation so recklessly made that culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception.

See also, Coleco Industries, Inc. v. Berman, 423 F. Supp. 275 (E.D.Pa. 1976), *aff'd*, 567 F.2d 569 (3d Cir. 1977). Based on the above quotations from those courts which have considered the meaning of recklessness since *Hochfelder*, it is apparent from a reading of the Ninth Circuit's opinion that that circuit is now in conflict with the other courts of appeal which have passed on this question. When it is remembered that this Court left for future determination the question whether "recklessness" will support recovery and the differing definitions of "recklessness" adopted by the several courts of appeal, it is obvious that there is a critical need for enunciation of an authoritative definition by this Court.

2. *Disclosure of the "Long-Range Plans" of the Control Group to Improve and Sell PRTA Was Not Material Under Tests Applied in 10b-5 Cases*

The determination of the trial court, upheld by the Ninth Circuit, that the defendants had violated section 10(b) and Rule 10b-5, was premised squarely on the nondisclosure by Coie of the existence of the so-called control group and its "outstanding, but still indefinite, plans to sell [PRTA] after construction and improvement had

conferred added value" (CCH at p. 93,409; Appendix, p. 32). Other claimed omissions, alone, would not have called for imposition of liability (FF. 27; R. 365, *see* CCH at p. 93,407; Appendix, p. 27-28).

Before analyzing the law of materiality as it applies to these "central" claimed omissions, it is worth noting the information which was disclosed or known to Korth, the attorney for plaintiff and his co-heirs. Korth had initially written *to the company itself*. He received a reply from Coie and assumed that Coie was the company's attorney (Korth Dep. p. 11). He learned during the course of the correspondence that Coie was acting on behalf of a man named Serwold. Korth had requested the company to transmit his request to "any source" that could give him the desired information. Coie's first letter indicated that Coie had sufficient access to PRTA to learn the status of the "R. Norman" stock on the corporate books, as well as indicating that Coie's principal wished to offer money for the shares, without clearance of title. Although the Ninth Circuit implied there was something sinister in Serwold's "private" response to the initial Korth inquiry through his personal attorney, Serwold's testimony completely explained his resort to Coie (Tr. 0019-20). He'd gotten a letter *from* an attorney and thought an attorney should answer it.

Prior to the consummation of the transaction, Korth obviously knew that Coie and Serwold had some close association with PRTA. The plaintiff Nelson testified that he thought that *the company itself* was purchasing the shares (Tr. 0089). Given this understanding it is difficult to comprehend why the acquisition of the shares by one who

headed a "control group" was an important matter which required disclosure.[5]

With respect to the "plans" of the "control group" to improve and sell PRTA, Serwold's only testimony as to his intentions was that he was trying to build a modern telephone company (Tr. 0021, 0030). The earliest feelers which had come from a potential purchaser came ". . . around 1965 or 1966" and had been rejected summarily (Tr. 0107). Coie's letter (Ex. D, *supra*) adequately apprised Korth and the heirs of the fact that the company had obtained financing which was committed to a *long-term capital improvement program.* Coie readily conceded his indefinite "hopes" that Serwold's improvement program would eventually render the investment of the four friends in their PRTA stock a profitable one (Tr. 0047-49), but no reported case has ever held that ". . . . private dreams, musings, aspirations and other remote hopes of the buyer of stock must be disclosed to the seller". *Thomas v. Duralite Co.*, 386 F. Supp. 698 (D.N.J. 1974).

Professor Bromberg in analyzing the extent to which potential sale or merger negotiations or discussions must be disclosed by an insider purchaser to a seller of corporate stock stated in volume 2, Bromberg, *Securities Law*, §7.4 (4)(b), p. 173:

> With this meager background one can make some projection of when a corporate transaction develops to the point of materiality. Taking an acquisition as an example, it will normally include most or all of these, not necessarily in this order: (1) conception and,

5. Had anyone connected with plaintiff inquired as to "control" they would have found more than half the shares were registered to Serwold. The fact that Serwold had obligations to others with respect to that ownership would hardly have been of interest to the sellers.

> perhaps, authorization of the next few steps, (2) investigation and analysis, (3) initial valuation, (4) negotiation, (5) fixing of terms by executives, (6) formal agreement by executives or directors, (7) shareholder approval, (8) implementation. Public announcement increasingly comes during (4), in which case it necessarily does not state the crucial dollar or ratio figures. If it comes after (5) or (6), which is probably the most common time, it can and should contain them. In contemplation of 10b-5, the information is probably material no later than the end of (5). And it may be much earlier, especially in a closely held company or direct-personal transaction, because of the absence of market indicators of value. Policy factors which support earlier materiality in such cases include the greater feasibility of communication, the absence of a general market which might overreact to the disclosure, and the probable dependence relation of the parties.

The cases decided both before and since Professor Bromberg made the above analysis uniformly hold that nebulous hopes or aspirations of corporate officials to make a future sale of acquired stock at a profit are not matters material enough to require disclosure. In *Hartnett v. Ryan Homes, Inc.*, 496 F.2d 832, 838 (3d Cir. 1974) it was contended that the chief officer and majority shareholder of a corporation should have disclosed to an employee of the company who was selling his shares back to the company the chief executive officer's unresolved intention to permit some corporate employees to sell their stock to the public. In affirming the judgment of the District Court holding that there had been no violation of 10b-5 the court of appeals held in words which could have been written about this case (p. 838):

> The district court's finding that these undisclosed cerebrations represented no more than a set of the numerous thoughts that separately occupy, at their

> early stages, slight portions of a business executive's time leads us to agree with the district court's conclusion that they were not material. In the corporate world, as elsewhere, the initial ruminations of executives must complete a circuitous course before becoming, if ever, actuality. Further if we were to require corporate officers to disclose inchoate ideas, musings as it were, on matters that relate to the value of their companies' stock, few stock transactions in which they participate would avoid the possible charge of a Rule 10b-5 violation.

In *List v. Fashion Park, Inc.*, 340 F.2d 457, 464 (2d Cir. 1965) negotiations for the sale of a corporation had commenced two days prior to the purchase by an insider of its stock. The defendant insider was unaware of the negotiations but knew that the company's board of directors had resolved to seek a sale and that there might be a purchaser on the horizon. The district court's finding that such information as the purchaser had was not material was upheld. *See also, Hassig v. Pearson*, 565 F.2d 644, 649-50 (10th Cir. 1977) and *Harkavy v. Apparel Industries, Inc.*, 571 F.2d 737, 741-42 (2d Cir. 1978) each of which clearly held that matters of mere speculation and conjecture as to the future course of conduct of the company whose shares were being purchased were not material enough to require disclosure to a seller by an insider purchaser.

3. *The Court of Appeals Finding of "Recklessness" Is Flatly Inconsistent With The District Judge's Findings and Violates F.R.C.P. 52(a)*

Except for its express disapproval of the trial court's determination that a full disgorgement remedy was inappropriate, the Ninth Circuit professes to affirm the findings of fact by the district court. However, even a cursory reading of the trial court's findings shows that the appellate

court chose to ignore them without even applying F.R.C.P. 52(a)'s "clearly erroneous" test.

The trial court observed both Serwold and Coie under the examination and cross-examination of opposing counsel. Judge Burns himself extensively and penetratingly interrogated Serwold (Tr. 0028-34, 0104-107), Coie (Tr. 0046-49, 0050-51), and Nelson (Tr. 0079-80).

The trial court explicitly found: that Serwold and Coie acted without scienter (Concl. of Law 1; R. 366); that neither "Mr. Serwold, or particularly Mr. Coie, deliberately and coldbloodedly set out to conceal information which 10b-5 requires to be provided" (FF. 28; R. 266); that Coie's dealings with Korth constituted "apparently a routine and rather minimal transaction" (Appendix, p. 4; R. 311-12); that the non-disclosure on which liability was premised did not occur "knowingly in the 'scienter' sense"; and that Serwold and Coie had not acted "willfully" or "deliberately" (Appendix, p. 8; R. 351, 352). Judge Burns specifically commented on his observation of Serwold and Coie on the stand: "In this the court relies to a considerable extent upon observation of the demeanor and manner of the witness when they testified." (FF. 28; R. 366). Observation of the bearing of witnesses under the stresses of adversarial examination is a significant advantage which a district court has over a court of appeals. It provides the express basis for F.R.C.P. 52(a)'s command that:

> Findings of fact shall not be set aside unless clearly erroneous, and due regard shall be given to the opportunity of the trial court to judge of the credibility of the witnesses.

This Court said in *Zenith Radio Corp. v. Hazeltine Research*, 395 U.S. 100, 123 (1969):

> In applying the clearly erroneous standard to the findings of a District Court sitting without a jury, appellate courts must constantly have in mind that their function is *not to decide factual issues de novo*. The authority of an appellate court when reviewing the findings of a judge as well as those of a jury, is circumscribed by the deference it must give to decisions of the trier of the fact, who is usually in a superior position to appraise and weigh the evidence.

In *United States v. Yellow Cab Co.*, 338 U.S. 338, 341 (1949), this Court earlier emphasized the particular deference which must be accorded the trial court's appraisal of evidence going to the issue of intent:

> Findings as to the design, motive and intent with which men act depend peculiarly upon the credit given to witnesses by those who see and hear them. If defendants' witnesses spoke the truth, the findings are admittedly justified. The trial court listened to and observed the officers who had made the records from which the Government would draw an inference of guilt and concluded that they bear a different meaning from that for which the Government contends.
>
> It ought to be unnecessary to say that Rule 52 applies . . . . There is no exception which permits [the Government] . . . to come to this Court for what virtually amounts to a trial de novo on the record of such findings as intent, motive and design.

Here liability was premised on the non-disclosure by Coie of information which, years after the fact, was determined to be "material" and which he was found to have had a technical duty to divulge. The trial court's determination of liability was made prior to the opinion in *Hochfelder*, in a sincere effort to apply the "flexible duty" standard of *White v. Abrams*, 495 F.2d 724 (9th Cir. 1974). There the requirement of scienter was subordinated to the application of a flexible "five factors" test. Although the opinion in *White v. Abrams* eschewed reliance on or even

further use of the terms "negligence" or "scienter" this Court observed in *Hochfelder, supra*, 425 U.S. at 193, n. 12, that *White v. Abrams*" . . . . held in substance that negligence alone is sufficient for civil liability" under 10b-5.

In concluding that Serwold and Coie must have been guilty of something more than "negligence" the court of appeals said:

> [t]he fact that the district judge never used the word "negligence", or any of its derivatives, in any of his findings of fact, conclusions of law, or opinions tends to indicate that he did not base his decision on a negligence theory.

CCH at p. 93,409; Appendix, p. 32. To say the least this is a non sequitur. When it is remembered that the flexible duty factors of *White v. Abrams, supra*, which the trial court was conscientiously attempting to apply *nowhere even mention the word negligence*, it is equally logical to assume that the trial court wasn't even willing to characterize defendants' conduct as "negligent"—that he was simply holding that under the *White* "duty" tests more factors favored plaintiff than defendants in determining defendants' *duty* to plaintiff.

In *John Nuveen & Co., Inc. v. Sanders*, 425 U.S. 929 (1976), this Court vacated and remanded a decision of the Seventh Circuit for reconsideration in light of *Hochfelder*. In *Sanders v. John Nuveen & Co., Inc.*, 554 F.2d 790 (7th Cir. 1977), the Seventh Circuit reversed its previous (524 F.2d 1064) determination of liability. The Ninth Circuit, notwithstanding *Hochfelder*, has adamantly refused to reverse the finding of liability in the present case. It omits any reference to the trial court's repeated determinations of a "lack of scienter". Instead of remanding the case to the trial court for a specific finding as to whether

"recklessness" was involved, the Ninth Circuit has made its own *de novo* determination on that issue. This usurpation of the province of the fact-finder under F.R.C.P. 52(a) alone provides this Court with ample cause to vacate the judgment of the Ninth Circuit and return the case to the district court for a further determination on the issue of "recklessness" if this Court finds such a conclusion possible considering Judge Burns' other findings and whatever definition of recklessness this Court may adopt as supporting recovery in a 10b-5 case.

4. *The Trial Judge Did Not Abuse His Equitable Discretion in Ruling on Damages*

If this Court determines either that the claimed omissions are not material or if it applies the *Hochfelder* rule to the determination by the district court that the defendants acted without scienter, then of course the question of the appropriateness of the district court's damage remedy need not be reached.

The conclusion of the Ninth Circuit that the damages in this case should be the paper profits on an exchange of the stock consummated 6½ years after the purchase of the Norman shares is unprecedented. No case in the securities law field has ever awarded to a seller the profits made by his purchaser on a resale which was not even in the talking stage at the time of the initial transaction and which consisted of a paper profit only.

In 1975 the Ninth Circuit said in *Blackie v. Barrack*, 524 F.2d 891, 909 (9th Cir. 1975) in a Securities Act case: "It is for the district judge, after becoming aware of the nature of the case, to determine the appropriate measure of damages in the first instance . . . ." Judge Burns did

just that. His Conclusion of Law No. 1 (R. 366) stated:

> The lack of scienter militates against the stricter rule of *Myzel v. Fields*, 386 F.2d 718, which calls for a complete disgorgement by persons who deliberately set out to cheat. Rather, the lack of scienter calls for a lesser measure of damages—more than the difference between price and market but one still below the *Myzel* measure. Plaintiff's damages should be calculated on the basis of the fair market value of the stock as of December 31, 1967, for the reason that this value represents the highest value reached by the stock within a reasonable time after the sale thereof. Plaintiff should be awarded $3,003.48.

Judge Burns had elaborated on the reasoning set forth in the above conclusion of law in a letter opinion to both counsel dated December 5, 1974. There he said, among other things (R. 351):

> I continue to rely upon the rationale in Professor Bromberg's statement that unless the fraud involved in Section 10b-5 violations of this nature is relatively severe, the constructive-trust approach provides an inappropriate remedy. (§9.1, p. 227, Vol. 3) As stated in my earlier opinion, I do not believe that the evidence justifies a finding that either Mr. Serwold or Mr. Coie willfully and deliberately set out to conceal information which Section 10b-5 requires. In each of the significant Section 10b-5 decisions where the disgorgement of future profits has been considered or applied, the fraud involved was both apparent and extensive as opposed to the omissions in this case. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965); *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972); *Rochez Bros., Inc. v. Rhoades*, 491 F.2d 402 (3rd Cir. 1974); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2nd Cir. 1973). No decision of which I am aware has required a defendant to disgorge profits earned more than two years after the original transfer. Neither *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375 (1970) nor *Baaumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969) pro-

vides a greater remedy. Therefore it seems incorrect to measure damages using as a yardstick either the present market value of United Telecommunications, Inc. stock or its value at the time of the 1972 sale.

Several other factors militate in favor of this decision. In both *Janigan* and *Rochez Bros.* the court considered but did not find that the defendants own effort had contributed to the increase in the value of the disputed stock during the intervening years between the original sale and resale. However, both decisions indicated that profit of this nature, where it exists, should not be subject to recovery by a seller-plaintiff. Here, where an extended period of time elapsed between sale and resale, it is apparent that the defendants' efforts between 1965 and 1972 contributed to the growth and increase in value of PRTA. A portion of what plaintiff claims as restitution would therefore be unrecoverable in any event.

Any effort to calculate money damages in this situation is made more difficult because of the lack of sales of PRTA stock during the years 1965 and thereafter until 1971. I see presently no alternative other than to use PRTA's book value as the appropriate fair market measure of damages, though I shall listen to any arguments to the contrary on December 17th. One or both may also wish to argue in favor of using either the 1966 or 1967 book value of the stock. I tentatively prefer the 1967 figure because I believe it best represents the "reasonable period of time" method of calculating damages as suggested by *Myzel, Janigan* and *Gerstle.* Although for reasons stated above I do not believe that plaintiff is entitled to recover damages measured by all the subsequent growth in value, I am of the impression that plaintiff's damages ought to be greater than simply the difference between book value and price paid in 1965. Despite the lack of deliberate and willful fraud in this case, the defendants' conduct does constitute a violation of the securities law and of plaintiff's rights. For these reasons I favor a more flexible Sec. 10b-5 damages remedy suited to the particular circumstances surrounding this case, as is encouraged by prior case law.

> Plaintiff could have discovered the inaccuracies of this transaction at the time it occurred in 1965, by asking for additional financial information about the company, including book value and earnings of PRTA stock. A "reasonable time period" should therefore be calculated from the date of sale. Prior case law is unspecific as to what constitutes a reasonable period. Most courts have arrived at a figure of between one and two years. None seem to have gone beyond this limit. Unless I am convinced by either party to the contrary, plaintiff's damages should not be measured beyond a suggested period of two years. I would expect to add interest and costs to this figure.

In riding roughshod over Judge Burns' careful and thoughtful assessment of the proper approach to damages, the Court of Appeals resorted to even more extreme "findings" than those which it made to support its theory of liability. It quoted with approval the rule stated in *Affiliated Ute Citizens v. United States,* 406 U.S. 128, saying: "This rule provides full compensation for injury caused by fraudulent conduct . . . ." When it is considered that Judge Burns did not regard the defendants' conduct as "fraudulent" in the common law sense (he repeatedly found the exact opposite) the reliance by the Ninth Circuit on the *Affiliated Ute* language is hard to understand.

The court of appeals further attempts to justify its total disgorgement conclusion by saying (Appendix, pp. 35-36):

> Finally we find that to refuse to award all of the accretion in value through the date of the discovery of the fraud would reward those who concealed their misconduct.

There wasn't an iota of evidence in the record that the defendants concealed anything. Under Judge Burns' view of the case the defendants could not have been aware of any misconduct because they did not act "knowingly". The

reference in the court of appeals opinion to concealment of misconduct was totally unsupported by any evidence in the record.

The section from Professor Bromberg referred to by Judge Burns in his letter opinion quoted above (Volume 3, §9.1, p. 227) concluded with the following statement: "[a] fairer measure would be the difference between the price and value at the time of the transaction, in symmetry with the buyer cases."

Chief Judge Friendly of the Second Circuit said in *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2d Cir. 1973) at 1304:

> We read all this as commanding the lower courts to do their best to achieve fair compensation for injured plaintiffs without being too draconian on defendants, at least in a situation where the inadequacy of a proxy statement may lie more in a failure of articulation than in an outright desire to deceive.

The above language is directly applicable to this case. Judge Burns' findings establish that in his judgment as the trier of the fact the omissions in Mr. Coie's correspondence lay ". . . . more in a failure of articulation than in an outright desire to deceive". While we of course urge that Judge Burns' assessment of the relatively mild nature of the 10b-5 violation he found requires dismissal of the entire action under this Court's *Hochfelder* decision we nevertheless believe that if this Court reaches the damage question, it should speak with clarity on the issue of a district court's right to base its damage award on its assessment of the seriousness of the violation. The Ninth Circuit has gone to unprecedented lengths in adopting the most "draconian" measure of all in a situation where the trial court was unable to find any conscious wrongdoing.

SUMMARY AND CONCLUSION

The district court, ruling prior to this Court's rendition of *Ernst & Ernst v. Hochfelder*, found that Serwold and Coie, in a "routine and rather minimal" transaction, had failed to disclose that the small number of shares involved were being purchased by a member of a "control group" which had hopes of improving and eventually realizing a profit on its investment in PRTA. The failure to make adequate disclosure was found to have been without deliberate intent and without consciousness of any misleading impact on the sellers. The lack of scienter, the passage of time, and the failure of the sellers to use due diligence all persuaded the trial court to calculate damages as of a reasonable period after the initial sale.

Disregarding the ruling in *Hochfelder* and other recent cases in the securities area decided by this Court, the court of appeals affirmed the trial court's finding of materiality, made its own *de novo* factual findings in concluding that defendants' acted "knowingly or recklessly", and reversed the trial court's judicious resolution of the damages issue.

The petitioners believe the granting of the requested Writ will correct a serious injustice and will result in clarification of difficult and important issues of securities law. Alternatively, should this Court deem it appropriate, petitioners pray that the Court summarily vacate the judgment of the court of appeals and direct it to return the case to the district court for further consideration and formulation of additional findings in light of *Hochfelder*.

Respectfully submitted,

By WILLIAM A. HELSELL
HELSELL, FETTERMAN, MARTIN,
TODD & HOKANSON

APPENDIX A

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

KENNETH N. NELSON, *Plaintiff*, v. O. E. SERWOLD and HELEN SERWOLD, his wife, *Defendants.*	Civil Action No. 411-72C2 OPINION

FILED IN THE
UNITED STATES DISTRICT COURT
Western District of Washington
OCT. 29, 1974
EDGAR SCOFIELD, *Clerk*
By ....., *Deputy*

At the time of the oral argument on September 20 I made certain findings on the record, which need be referred to only briefly here. Essentially, my findings were that as to the Plaintiff's claim of 10b-5 violations contained in Mr. Coie's correspondence with Mr. Korth, I did not either find or conclude that these statements with respect to a) non-declaration of dividends, b) available surplus for dividends, and c) mortgage restrictions on dividend payment, amount in fact or in law to material misrepresentations which would expose Defendant to 10b-5 liability. I left open the question of whether the claimed omissions in the correspondence would amount in fact and law to 10b-5 violations. I did state at the time concerning those claimed omissions that the failure only to send a 1962

financial statement, (or a 1964 financial statement when the correspondence resumed in 1965) would not be sufficient for Plaintiff to prevail under 10b-5. I also suggested that, standing alone, the failure of the correspondence in 1965 to describe financial progress of the company during the intervening period in terms of earnings, income, book value increases, etc., similarly would not bring about a finding of omission liability under 10b-5.

As I indicated, the troublesome area came for me when considering the omissions in their entirety, particularly the two latter ones we discussed. These two may be generally described as, first, the failure to disclose the informal and somewhat amorphous long-range intent of the "control group" to acquire majority shares, build up the company and to sell, and, secondly, failure to reveal the existence of the "control group" itself wherein the approximately 56% acquired in Mr. Serwold's name alone was in fact acquired by Serwold, Iverson, Gee and Coie on the 30/30/30/10 per cent basis.

I have now had the benefit of one final addition of letter memo from each of you, and I rule on the matter as follows:

I conclude, after much thought and reflection and considerable rereading of the cases cited, particularly *White v. Abrams*, 495 F.2d 724 (9 Cir. 1974), that a combination of these omissions is sufficient to add up to material omissions within the meaning of 10b-5. To whatever extent causation and reliance are necessary in a non-disclosure case, I find and conclude that those elements are present as well.

It is true that the evidence showed the plans of the control group to be somewhat inchoate as of 1965. Nonetheless, the evidence justifies the finding that the intent to buy up a majority, finance to improve and then sell, was sufficiently ripened to be a factor upon which a reasonable investor would have relied. This was a matter in which a reasonable investor would have been interested and about which he would have been concerned, had he known of it. Moreover, the evidence preponderates in favor of a finding that a reasonable investor's conduct would have been influenced by knowledge of the existence of the "insider" control group, particularly as it would take on additional meaning when coupled with knowledge of the somewhat indefinite, but certainly existent, plans outlined above.

Furthermore, when considering these interrelated factors, a reasonable investor, I believe, would certainly be influenced in making his sale decision by the knowledge of the increase in the financial status whereby the net income per share went from $3.43 in 1962, to $6.71 in 1963, and also $5.44 in 1964. This would be particularly true of a potential seller who was initially advised that the purchase price was in the $5.00 per share range. During the same period of time the book value per share went from $36.20 in 1962 to $51.28 in 1964. This fact, if known, would likewise have influenced a seller's conduct.

In short, I conclude that the evidence preponderates on this issue in Plaintiff's favor, and, hence, that omission liability under 10b-5 exists.

In doing so, I have attempted to apply the flexible duty standard called for by *White v. Abrams*, particularly the five factors which the *White* Court said ought to be examined in determining the standard of conduct to be observed. Factor No. 1, the relationship of the parties, tends

to favor Defendant, since Coie and Korth, from all that appears, were simply two lawyers, one in Wisconsin and one in Washington, carrying on what was apparently a routine and rather minimal transaction—not at all unusual in the probating of estates of people of the age of the decedent.

The second factor involves comparing access to the information of the Defendant to that of the Plaintiff. This militates strongly in Plaintiff's favor despite the fact that some of the information itself would have been available in the public records of the regulatory agency in Washington, and that Korth nowhere specifically asked for financial information as opposed to "status." Despite these factors, Korth was in Wisconsin involved in what was, for him, a routine and minimal matter. He would not be likely to be making extensive inquiries concerning 36 shares of an undistinguished rural telephone company half way across the country. This is particularly true where the original correspondence suggested a value of only $5.00 a share but where the book value as of the end of 1964 was known at least to Serwold—if not to Coie—to be ten times that amount and where the improvements which would confer additional value on the company, and therefore, its stock, were well underway.

The third factor in *White* relates to the benefit which the Defendant derives from the transaction. This also strongly militates in Plaintiff's favor. While the initial offer of $5.00 a share was rejected, the second offer of about $7.00 per share was accepted, leaving the sale price at a tiny percentage of the then book value.

The fourth factor of *White* deals with Defendant's awareness of whether Plaintiff was relying upon their relationship in making investment decision. While this is not as strong as factors 2 and 3, nonetheless, it is not hindsight alone which confers importance on this curious congeries of circumstances. These factors existed: a) an "insider" control group; b) the outstanding, but still indefinite plans to sell after building and improvement had conferred added value; c) the steady and significant increases in earnings and book value in the few years between the opening inquiry and the sale. This combination ought to have made Coie, as a capable and experienced lawyer, aware that Korth must have been relying to rather considerable extent on the relationship between himself and Coie in making an investment decision, and in disclosing those things which a seller would be likely to want to know.

The fifth *White* factor (Defendant's activity in initiating the transaction) lands largely on Defendant's side of the fence.[1]

It is my recollection that at the time of trial, it was agreed that essentially we would try only the issue of liability. Questions relating to measure of damages would be severed so that in the event Defendant prevailed, time of both Court and counsel would be saved.

Consequently, I assume further hearing will be required as to the matter of damages, but I add the following tentative thoughts that I presently have on the damage question.

---

1. Hence, I conclude, as a matter of fact and of law, that omission liability under 10b-5 has been established. This analysis makes unnecessary any detailed discussion of the dovetailing of the "insider" rule, *Texas Gulf Sulphur*, 401 F.2d 833 (2 Cir. 1968). The concepts (failure to disclose existence of and plans by the "control group" and the "insider" rule) tend to coalesce, however, and it would be a mistake to assume that I have ignored the insider factors present here.

The materials cited by Defendant in his trial brief are fairly persuasive in favor of a measure of damages involving the difference between the purchase price and fair market value at the time in question. The measure urged by Plaintiff would reach "forward" and require a 10b-5 violator to disgorge "profits" which came to him as a result of accrual in value of the stock from the time of acquisition until the subsequent sale. Professor Bromberg (§9.1 p. 227, Vol. 3) suggests that it is only a particularly severe sort of wrongdoing in which this latter measure is ordinarily used. In this respect, it seems to me that the factor of scienter assumes importance.

As I read *White*, scienter in non-disclosure cases is not an essential element, at least in terms of establishing liability. I certainly cannot say from the evidence that the non-disclosure which I have now found to be omissions prohibited by 10b-5 occurred knowingly in the "scienter" sense.

I do not believe that the evidence justifies a finding that either Mr. Serwold, or particularly Mr. Coie, deliberately and cold-bloodedly set out to conceal information which 10b-5 requires to be provided. This is particularly true with a small block of stock which, after all—even in 1965—had the book value of only about $1,800. In this, I rely to a considerable extent upon my observation of the demeanor and manner of the witnesses when they testified before me. Consequently, this lack of scienter would tend to militate against the stricter rule of *Myzel*, which calls for complete disgorgement by persons who deliberately set out to cheat. Rather, the lack of scienter would tend to call for a lesser measure of damages—perhaps the difference between price and market, or perhaps a formula which would

achieve a higher figure, but one still below the *Myzel* measure. All of this, however, as to the proper measure is tentative on my part.

However, I do not specifically decide this question, but, rather, call for brief written response from each of you as to the following:

a) Do you desire a factual hearing on the measure of damages;

b) If so, please indicate the number of witnesses you intend to call and the expected length of their testimony;

c) Do you desire further briefing or oral argument on the question of what measure of damages should be applied?

I assume that if the measure of damages which is finally applied is either the sale price to United or, alternatively, present market price of the United stock, those two facts could be stipulated and would not necessitate testimony.

Dated this 25th day of October, 1974.

s/ JAMES M. BURNS
Judge

APPENDIX B

UNITED STATES DISTRICT COURT
DISTRICT OF OREGON
PORTLAND 97205

CHAMBERS OF
JUDGE JAMES M. BURNS December 5, 1974

Mr. William D. Cameron
Williams, Lanza, Kastner & Gibbs
1440 Washington Building
Seattle, Washington 98101

Mr. William A. Helsell
Helsell, Paul, Fetterman,
Todd & Hokanson
Washington Building
Seattle, Washington 98101

Re: Nelson v. Serwold
USDC WD Wash 411-72-C2

Gentlemen:

I am responding to your recent memos concerning the issue of damages in *Nelson v. Serwold*. Our final hearing on this matter is scheduled for December 17th at 3:30 P.M. in the Court of Appeals Courtroom in Seattle. I remain unconvinced that this case requires the exceptional remedy of restitution (or its equivalent) as claimed by Plaintiff. I continue to rely upon the rationale in Professor Bromberg's statement that unless the fraud involved in Sec. 10b-5 violations of this nature is relatively severe, the constructive-trust approach provides an inappropriate remedy. (Sec. 9.1 p. 227, Vol. 3) As stated in my earlier opinion, I do not believe that the evidence justifies a finding that either Mr. Serwold or Mr. Coie wilfully and deliberately set out to conceal information which Sec. 10b-5 requires. In each of the significant Sec. 10b-5 decisions where the disgorgement of future profits has been considered or applied, the fraud involved was both apparent and extensive as opposed to the omissions in this case. *Myzel v. Fields*, 386 F.2d 718 (8th Cir. 1967); *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965); *Affiliated Ute Citizens v.*

United States, 406 U.S. 128 (1972); *Rochez Bros. v. Rhoades*, 491 F.2d 402 (3rd Cir. 1974); *Gerstle v. Gamble-Skogmo, Inc.*, 478 F.2d 1281 (2nd Cir. 1973). No decision of which I am aware has required a defendant to disgorge profits earned more than two years after the original transfer. Neither *Mills v. Electric AutoLite Co.*, 396 U.S. 375 (1970) nor *Baumel v. Rosen*, 412 F.2d 571 (4th Cir. 1969) provides a greater remedy. Therefore it seems incorrect to measure damages using as a yardstick either the present market value of United Telecommunications Inc. stock or its value at the time of the 1972 sale.

Several other factors militate in favor of this decision. In both *Janigan* and *Rochez Bros.* the Court considered but did not find that the defendant's own effort had contributed to the increase in the value of the disputed stock during the intervening years between the original sale and resale. However, both decisions indicated that profit of this nature, where it exists, should not be subject to recovery by a seller-plaintiff. Here, where an extended period of time elapsed between sale and resale, it is apparent that defendants' efforts between 1965 and 1972 contributed to the growth and increase in value of PRTA. A portion of what plaintiff claims as restitution would therefore be unrecoverable in any event.

Any effort to calculate money damages in this situation is made more difficult because of the lack of sales of PRTA stock during the years 1965 and thereafter until 1971. I see presently no alternative other than to use PRTA's book value as the appropriate fair market measure of damages, though I shall listen to any arguments to the contrary on December 17th. One or both may also wish to argue in favor of using either the 1966 or 1967 book value of the stock. I tentatively prefer the 1967 figure because I believe it best represents the "reasonable period of time" method of calculating damages as suggested by *Myzel*, *Janigan*, and *Gerstle*. Although for reasons stated above I do not believe that plaintiff is entitled to recover damages measured by all the subsequent growth in value, I am of the impression that plaintiff's damages ought to be greater than simply the difference between book value and price paid in 1965. Despite the lack of deliberate and wilfull fraud in this case, the defendants' conduct does constitute

a violation of the securities law and of plaintiff's rights. For these reasons I favor a more flexible Sec. 10b-5 damages remedy suited to the particular circumstances surrounding this case, as is encouraged by prior case law.

Plaintiff could have discovered the inaccuracies of this transaction at the time it occurred in 1965, by asking for additional financial information about the company, including book value and earnings of PRTA stock. A "reasonable time period" should therefore be calculated from the date of sale. Prior case law is unspecific as to what constitutes a reasonable period. Most courts have arrived at a figure of between one and two years. None seem to have gone beyond this limit. Unless I am convinced by either party to the contrary, plaintiff's damages should not be measured beyond a suggested period of two years. I would expect to add interest and costs to this figure.

I believe this is an equitable result and in the absence of persuasion to the contrary at the hearing, I propose to formalize it by an appropriate order after the 17th. I have already indicated those areas where further discussion might be useful, and would appreciate having your remarks on the 17th confined to those topics. I am willing to hear testimony as to the method of evaluating PRTA stock or the year in which evaluation should take place, if you find this relevant. Such testimony should of necessity be brief. Please advise my law clerk, Stephen Moore (503-221-3908) by phone and confirming letter of the names of any witnesses you intend to call and a summary of what you expect each will say.

Very truly yours,

s/ JAMES M. BURNS
James M. Burns

JMB/i

APPENDIX C

UNITED STATES DISTRICT COURT
WESTERN DISTRICT OF WASHINGTON
AT SEATTLE

KENNETH N. NELSON, *Plaintiff,* v. O. E. SERWOLD and HELEN SERWOLD, his wife, *Defendants.*	Civil No. 411-72C2 FINDINGS and CONCLUSIONS

FILED IN THE
UNITED STATES DISTRICT COURT
Western District of Washington
SEPT. 29, 1975
EDGAR SCOFIELD, *Clerk*
By....., *Deputy*

This matter having come on for trial before the undersigned, Judge of the United States District Court for the District of Oregon, sitting by designation in the Western District of Washington, plaintiff appearing by and through William D. Cameron and defendants by and through William A. Helsell, and the following proceedings having taken place:

(a) The Court proceeded to take testimony on May 7, 1974, with respect to issues relating to liability;

(b) Thereafter, the Court heard oral argument on September 20, 1974, and made certain findings on the record as to certain aspects of the case; this oral opinion, when transcribed, will be filed with the Clerk and treated as Findings and Conclusions under the provisions of Rule 52;

(c) Thereafter, on the 25th day of October, 1974, the Court issued and filed a written opinion ruling on the remaining matters as to liability, which opinion includes Findings and Conclusions pursuant to Rule 52; that opinion discussed, but did not resolve, the damage issues; it merely expressed tentative views by the Court on measure of damages and called for the scheduling of further hearings as to damages;

(d) On December 5, 1974, the Court issued and filed a written opinion containing Findings and Conclusions as to certain aspects of the damage issue;

(e) On December 17, 1974, a further hearing was held concerning the issue of damages, at which testimony was taken and other evidence received, and the parties orally argued the matter of damages to the Court;

(f) Thereafter, on the 23 day of January, 1975, the Court issued and caused to be filed a further written opinion finally resolving the damages question, which opinion contains Findings and Conclusions.

Thereafter, the Court invited the parties to submit a complete set of Proposed Findings and Conclusions; plaintiff had earlier submitted Proposed Findings and Conclusions; and defendant had submitted its Proposed Findings and Conclusions; each side has submitted letter-comments as to the other's proposals; thereafter, oral argument was held in Portland, Oregon, on September 10, 1975; the Court now enters the following Findings and Conclusions, it being understood that each of the previous referred to Findings and Conclusions are incorporated by reference herein, namely, (1) the Court's oral opinion of September 20, 1974, when transcribed and filed; (2) the Court's written

opinion as to liability dated the 25 day of October, 1974, and the Court's two letter-opinions vis-a-vis damages dated the 5 day of December, 1974, and 23 day of January, 1975:

FINDINGS OF FACT

1. Jurisdiction is vested in this court by virtue of 28 U.S.C. 1331 and §27 of the Securities Exchange Act of 1934 (15 U.S.C. §78aa) for alleged violations of Section 10(b) of said Act [15 U.S.C. §78j(b)] and Rule 10b-5 (17 C.F.R. §240.10b-5), and R.C.W. 21.20.010. This court has pendent jurisdiction over related state claims.

2. Plaintiff is a resident of Mill Valley, California.

3. Defendants are residents of Poulsbo, Washington, and constitute (and did at all times herein constitute) a marital community.

4. Poulsbo Rural Telephone Association, hereinafter referred to as "PRTA" is a Washington corporation, having its principal and only office in Poulsbo, Washington.

5. PRTA was organized in 1908 as a profit corporation and until 1972 was authorized to do business as a telephone utility serving the Poulsbo, North Kitsap County, Washington, area.

6. PRTA sold substantially all of its assets in January, 1972, and on March 7, 1972, filed with the Secretary of State its statement of intent to dissolve.

7. At all times herein, the total number of authorized shares of PRTA was 10,000, of which 7,123 shares were issued and outstanding and owned of record by about 150 shareholders.

8. At all times herein, PRTA's president was defendant O. E. Serwold, whose PRTA salary was $24,000 per year.

9. At all times herein, defendant O. E. Serwold was a director of PRTA. So also was defendant Helen Serwold a director.

10. At all times herein, defendants Serwold owned of record over 50% of PRTA's issued and outstanding shares of stock.

11. J. Paul Coie, hereinafter referred to as "Coie," whose law firm was formerly known as Holman, Marion, Black, Perkins & Coie, is, and at all times herein was, an attorney at law licensed to practice law in the State of Washington.

12. Earl A. Korth, hereinafter referred to as "Korth," is, and at all times herein was, an attorney at law licensed to practice law in the State of Wisconsin.

13. In September, 1965, defendant O. E. Serwold, acting through Coie, his attorney, purchased 36 shares of PRTA, represented by its Stock Certificate No. 305, for the sum of $250. Exhibits "A" through "N" and "FF-1" and "GGG-2" reflect the entirety of that transaction. Each said exhibit is a true and genuine copy of the original of which it purports to be. Each said exhibit which is a letter was prepared and signed by the indicated author-signatory, was mailed to the indicated addressee on or about the designated date of the exhibit and was received by the addressee in the ordinary course of postal delivery. Each such letter which indicates in the lower, left-hand corner thereof that a copy of the letter was directed to a designated person was in fact mailed to such designated person on or about the designated date of the letter and was received by such person in the ordinary course of postal delivery, together with all enclosures therein referred to as being sent with such copy of letter to said person. Likewise, all enclosures

referred to in any such letter were in fact enclosed with such letter and were received therewith by the addressee.

14. With respect to the sale of said Certificate No. 305 to O. E. Serwold for $250, all sale negotiations and communications between buyer(s) and seller(s), including the consummation of the transaction, were carried on exclusively by use of the United States mails directly between Coie and Korth, except the initial communication, Ex. "A", was mailed from Korth to PRTA.

15. The copy of the Judgment of Assignment (Final Judgment), Ex. "N", referred to in Ex. "E", was delivered to Coie with the copy of that letter (Ex. "E"). Ex. "N" is a true and genuine copy of the copy of said Judgment which was delivered to Coie as an enclosure to Ex. "E". The handwritten note "copy sent to Serwold 7/12/65" appearing on page 2 of Ex. "F" was written by Coie upon the original of said letter after he received the same.

16. The Nilsson affidavit (Ex. "I") and PRTA Stock Certificate No. 305 (Ex. "J") referred to in Ex. "H" were delivered to Coie with the original of that letter. Ex. "I" and "J" are true and genuine copies of said affidavit and stock certificate.

17. PRTA Stock Certificate No. 305 (Ex. "J") for 36 shares was issued to R. (Richard) Norman in 1911.

18. Exhibits "Q", "R", "S", "T" and "U" are each true and genuine copies of the original of which each purports to be, such exhibits being financial statements by PRTA's certified public accountants for the years 1962, 1963, 1964, 1965 and 1971, respectively. Each such financial statement shows PRTA's financial condition on December 31 of each respective year and the results of PRTA's operations during

each respective calendar year in accordance with PRTA's books and records.

19. From February through December, 1965, the most current financial statement of PRTA (other than any that may have been prepared for internal use only) was Ex. "S", a Statement of Financial Condition on December 31, 1964 (Balance Sheet) and a Statement of Profit and Loss for the year ending December, 1964.

20. Neither plaintiff, his brother, Herbert Nilsson, their sister, Gladys Lawrence, or their attorney, Korth, was ever a shareholder of record of PRTA.

21. In 1965 the only contractual restriction or "mortgage commitment" pertaining to declaration or payment of dividends by PRTA was contained in a certain "Second Supplemental Real Estate and Chattel Mortgage" dated October 21, 1959, between PRTA (the "Mortgagor") and Pacific Mutual Life Insurance Company. The restriction reads as follows:

"7. DIVIDEND RESTRICTION

Mortgagor covenants until the loan is fully paid it will not pay any dividends on any class of its capital stock, except dividends payable in its stock, or acquire for value any shares of its outstanding stock, until Mortgagor's capital and surplus equal at least One Hundred Twenty Thousand Dollars ($120,000.00) provided current assets are at least equal to or greater than current liabilities (and for the purposes of this subsection current liabilities shall not include bank loans incurred for capital expansion) and then only from earnings accumulated thereafter as follows:

(a) No dividend whatever during such time as the ratio of mortgage debt to plant is 55% or more.

(b) Seventy-five per cent (75%) of accumulated earnings during such time as the ratio of debt to net

plant exceeds forty-five per cent (45% but is less than fifty-five per cent (55%).

(c) One hundred per cent (100% of accumulated earnings when the ratio of debt to net plant is forty-five per cent (45%) or less."

22. As of January 18, 1966, PRTA borrowed $80,000 at an interest rate of 5.18% per annum from Pacific Mutual Life Insurance Company, the loan to mature November 1, 1985. Prior to maturity of the loan, PRTA was required to pay no more than $1,600 principal, beginning on November 1, 1966, and on November 1 of each year thereafter while any part of the principal remained unpaid, together with said interest which was payable semiannually on May 1, and November 1 of each year until the loan was fully paid, the first interest payment to commence on November 1, 1966. The loan was obtained for purpose of capital expansion.

23. From after 1956 and throughout the year 1965 and until approximately June, 1971, defendants Serwold, Rudie Iversen, his wife, Evelyn Iversen, W. H. Gee and Coie, were parties to a continuing agreement or arrangement among them by which all, or substantially all, of the PRTA stock owned of record, or which might be acquired by any of them, was beneficially owned approximately 30% each by (a) defendants Serwold, (b) Iversen and wife and (c) Gee, and approximately 10% was beneficially owned by Coie.

24. PRTA's net income after all taxes, including federal income tax, was as follows during the ten years, 1962-1971, inclusive:

Year	Net Income	Net Income Per Share Based on 7,123 Shares Issued and Outstanding Throughout the Period
1962	$24,466	$ 3.43
1963	47,762	6.71
1964	38,789	5.44
1965	55,651	7.31
1966	73,332	10.30
1967	65,430	9.19
1968	59,925	8.41
1969	142,966	20.07
1970	182,989	25.68
1971	218,449	30.67

PRTA's retained earnings and surplus and the book value per share of its issued and outstanding stock, as reflected by the books and records of PRTA as of December 31, in each of the ten years, 1962-1971 inclusive, were as follows:

Year	Retained Earnings & Surplus*	Book Value Per Share**
1962	$ 257,867	$ 36.20
1963	320,184	44.95
1964	365,300	51.28
1965	420,951	59.10
1966	494,283	69.39
1967	559,713	78.58
1968	619,638	86.99
1969	762,604	107.06
1970	945,593	132.75
1971	1,164,042	163.42

*Stated to nearest dollar.

**Calculated as follows: Stockholders' equity (being the net worth of the corporation) divided by the number of the Association's issued and outstanding shares of stock (being 7,123).

25. On or about December 5, 1966, O. E. Serwold presented Certificate No. 305 (Ex. "J") to PRTA for registration of transfer to him. When O. E. Serwold presented Stock Certificate No. 305 (Ex. "J" to PRTA for registration of transfer to him as a purchaser for value, he did not advise the corporation of any fact which might impair the validity of the certificate or of its assignment or transfer to O. E. Serwold.

26. None of the statements contained in Mr. Coie's correspondence with Mr. Korth pertaining to (a) nondeclaration of dividends (b) available surplus for dividends, and (c) mortgage restrictions on dividend payments, amounted to material misrepresentations, within the meaning of Rule 10b-5, or its counterpart under the state securities laws.

27. Within the meaning of Rule 10b-5 and its state counterpart, I find that omission liability exists considering the various omissions in their entirety but particularly concentrated on the two central areas of omissions as follows: Mr. Coie's failure to disclose the informal and long-range intent of the "control group" to acquire majority shares, to build up the company and to ultimately sell it, and his failure to reveal the existence of the "control group" itself under which 56% of the stock in PRTA which had been acquired in Mr. Serwold's name alone was in fact acquired by Serwold, Iversen, Gee and Coie in the ratio of 30%, 30%, 30% and 10%, respectively, constituted material omissions of fact within the meaning of Rule 10b-5. These were matters about which a reasonable investor would have been interested and which would have influenced the conduct of such a reasonable investor.

28. There was no evidence to justify a finding that either Mr. Serwold, or particularly Mr. Coie, deliberately and

cold-bloodedly set out to conceal information which 10b-5 requires to be provided. This is particularly true with a small block of stock which, after all—even in 1965—had the book value of only about $1,800. In this, the court relies to a considerable extent upon observation and demeanor and manner of the witnesses when they testified.

29. The fair market value of PRTA stock as of December 31, 1967, was the sum of $90.37 per share. The purchase price of the stock acquired by defendant from plaintiff in September, 1965, was $6.94 per share. Accordingly, the difference between the purchase price and the fair market value as of December 31, 1967, was $3,003.48.

From the foregoing Findings of Fact the court now makes and enters the following:

CONCLUSIONS OF LAW

1. The omissions from Mr. Coie's correspondence referred to in the Findings of Fact constituted violations of Section 10b-5 of the Regulations promulgated by the Securities Exchange Commission (17 C.F.R. § 240.10b-5), and of its Washington State counterpart, R.C.W. 21.20.010. The lack of scienter militates against the stricter rule of *Myzel v. Fields*, 386 F.2d 718, which calls for complete disgorgement by persons who deliberately set out to cheat. Rather, the lack of scienter calls for a lesser measure of damages—more than the difference between price and market, but one still below the *Myzel* measure. Plaintiff's damages should be calculated on the basis of the fair market value of the stock as of December 31, 1967, for the reason that this value represents the highest value reached by the stock within a reasonable time after the sale thereof. Plaintiff should be awarded $3,003.48.

2. Plaintiff should be awarded interest on the amount of damages awarded herein from September 16, 1965, at the rate of 8% per annum, together with plaintiff's costs and disbursements herein to be taxed.

Dated this 26th day of September, 1975.

/s/ JAMES M. BURNS
Judge

APPENDIX D

JUDGMENT ON DECISION BY THE COURT CIV 32 (7-63)

UNITED STATES DISTRICT COURT FOR THE WESTERN DISTRICT OF WASHINGTON, AT SEATTLE

KENNETH N. NELSON, v. O. E. SERWOLD and HELEN SERWOLD, his wife,	Civil Action File No. 411-72C2 JUDGMENT

FILED IN THE
UNITED STATES DISTRICT COURT
Western District of Washington
and entered on docket
SEPT. 29, 1975
EDGAR SCOFIELD, *Clerk*
By....., *Deputy*

This action came on for trial before the Court, Honorable James M. Burns, United States District Judge, presiding, and the issues having been duly tried and a decision having been duly rendered, and findings and conclusions having been filed herein,

It is Ordered and Adjudged that plaintiff Kenneth N. Nelson recover of the defendants O. E. Serwold and Helen Serwold, his wife, the sum of $3,003.48, with interest thereon at the rate of 8% per annum from September 16, 1965, together with costs and disbursements in the sum of $483.98 to be taxed.

Dated at Seattle, Washington, this 29th day of September, 1975.

/s/ EDGAR SCOFIELD
Clerk of Court

APPENDIX E

IN THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

KENNETH N. NELSON, *Plaintiff-Appellant,* v. O. E. SERWOLD and HELEN SERWOLD, his wife, *Defendants-Appellees.*	No. 76-1001 OPINION
KENNETH N. NELSON, *Plaintiff-Appellee,* v. O. E. SERWOLD and HELEN SERWOLD, his wife, *Defendant-Appellants.*	No. 75-3833

FILED
APRIL 3, 1978
EMIL E. MELFI, JR.
Clerk, U.S. Court of Appeals

Appeal from the United States District Court
for the Western District of Washington

Before: KOELSCH and WRIGHT, Circuit Judges, and CALLISTER, District Judge.*

PER CURIAM:

The plaintiff, Kenneth N. Nelson, was awarded $3,003.48 plus interest and costs in this 10b-5 action against defendants Serwold. They were found to have violated Rule 10b-5 of the regulations promulgated under § 10b of the 1934 Securities and Exchange Act (hereinafter "Act"), and its Washington counterpart, RCW § 21.20.010, by failing to reveal the existence of the "control group" under which 56% of a telephone company's stock, held in the name of O. E. Serwold, was in fact beneficially owned by Serwold

*Of the District of Idaho.

and other members of the "group," and by failing to disclose an informal, long-range intent of the "control group" to modernize the telephone company and ultimately to sell it.

Plaintiff asserts on appeal that the district court erred by not basing relief on a rescissory theory of damages requiring a complete disgorgement of profits.

On their cross-appeal, defendants contend that the omissions in the representations made through their attorney were not material. They also insist that *Ernst & Ernst v. Hochfelder*, 425 U.S. 185 (1976), decided after the district court's determination, requires reversal in light of the district court's finding of an absence of scienter.

We believe that the district court's finding that defendants failed to disclose material matters is amply supported by the evidence. We also believe the evidence supports a finding that the defendants acted knowingly or recklessly, a standard adequate to support Rule 10b-5 liability after *Ernst & Ernst*.

Finally, we reverse on the issue of damages, and remand so that the district court can recompute plaintiff's damages based on a rescissory theory. *Affiliated Ute Citizens v. United States*, 406 U.S. 128 (1972).

FACTS

Poulsbo Rural Telephone Association (Poulsbo Telephone), a Washington corporation, was formed in 1908. Serwold was employed there as a lineman in the 1930's and became its president in 1957. He and his wife were directors of the company.

Serwold desired to modernize the company's equipment and install a dial system. He applied for a loan from Pacific Mutual Life Insurance Company in the mid-1950's.

Poulsbo Telephone's attorney advised him to obtain "control" of the company so that he could deal effectively with the lender. Because he did not have funds to acquire control, he discussed the matter with social friends Rudie and Evelynn Iversen, William H. Gee, and J. Paul Coie. In 1956, the Serwolds, the Iversens, Gee, and Coie agreed to pool cash sufficient to acquire a controlling interest. Stock so acquired was to be owned of record by Serwold and beneficially owned as follows: approximately 30% for the Serwolds, 30% for the Iversens, 30% for Gee, and 10% for Coie. The group's desire to modernize was motivated, at least in part, by its plan to develop the company into a marketable enterprise. It acquired 56% of Poulsbo Telephone's stock as of 1959 and thereafter Serwold discontinued active efforts to acquire more stock.

On October 17, 1962, Earl A. Korth (Korth), a Wisconsin attorney, wrote to Poulsbo Telephone advising that stock certificate No. 305 for 36 shares issued to R. Norman had been found in his file in the Estate of Nels Nelson, Deceased. Korth asked information on the "status" of the stock. Serwold referred the letter to Coie who responded on December 11, 1962 that, upon receipt of "satisfactory evidence of present ownership, we . . . may be in a position to offer $5.00 per share." No other information about the status of the stock was provided.

Korth wrote to Coie on January 22, 1963, showing ownership in the Nelson Estate and inquiring whether "any dividends . . . are accrued." There was no response for 27 months, during which time the Nelson Estate was closed. The administrator, Herbert Nilsson, retained the certificate in a safe deposit box.

On April 15, 1965, Coie wrote Korth:

If you will give us an affidavit and surrender Cer-

> tificate #305 for 36 shares . . ., the enclosed check of O. E. Serwold . . . in the sum of $180.00 may be cashed.
>
> There have been no dividends ever declared since the formation of this company, and none can be anticipated for years because of mortgage commitments required to finance capital improvements. This is a regulated utility and there has never been a surplus from which dividends could have been declared.

In a letter to Nilsson on April 20, 1965, Korth indicated that he assumed that the $180.00 represented the fair market value of the stock. Coie received a copy of that letter. Nilsson relayed the information to the plaintiff. On July 9, 1965, Korth wrote Coie inquiring "whether or not Mr. Serwold would be willing to pay $250 [$6.94 per share] for the stock." Coie agreed and forwarded another Serwold check for the additional sum. In 1965, Poulsbo Telephone stock had a book value of approximately $60.00 per share.

Thereafter, on September 16, 1965, Korth mailed to Coie the endorsed stock certificate No. 305 and Nilsson's affidavit tracing ownership to the Nelson Estate.

Serwold, as president of Poulsbo Telephone, first received "feelers" in 1965 or 1966 from persons interested in purchasing all or part of the company's stock. In 1968 or 1969, Serwold and Telephone Utilities, Inc., of Ilwaco, Washington, discussed a possible sale of Poulsbo Telephone. Negotiations with United Utilities, Inc. (United), of Hood River, Oregon, began in December 1970, and resulted in the sale of all Poulsbo Telephone assets in 1971.

Under the Agreement and Plan of Reorganization, Poulsbo Telephone exchanged all its assets for United stock, which it then distributed to its shareholders. Poulsbo

Telephone shareholders received 25 shares of United stock (a value of $500) for each share of Poulsbo Telephone. At the time of the exchange, Poulsbo Telephone stock had a book value of approximately $163.00 per share.

In 1971, plaintiff received a letter from Richard Peterson, R. Norman's nephew, alluding to the proposed transaction between Poulsbo Telephone and United. He then retained counsel and sued on June 20, 1972, having first obtained assignments from other relatives.

Over a two-year period the district court heard evidence and issued an oral opinion on September 20, 1974, a written opinion of October 25, 1974 as to liability, two letter-opinions on damages dated December 5, 1974, and January 23, 1975, and Findings of Fact and Conclusions of Law on September 29, 1975.

DISCUSSION

I. RULE 10b-5 LIABILITY.

Material Omission

Rule 10b-5 makes it unlawful "to make any untrue statement of a material fact or to omit to state a material fact necessary . . . to make the statements made, in the light of the circumstances under which they were made, not misleading. . . ." 17 C.F.R. § 240.10b-5. A statement or an omission is material if it reasonably could have been expected to influence the decision to sell. *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 153 (1972).

The district court concluded that Coie's representations to Korth with respect to (a) nondeclaration of dividends, (b) available surplus for dividends, and (c) mortgage restrictions on dividend payments did not amount to ma-

terial misrepresentations which would expose defendants to Rule 10b-5 liability. The evidence supports these conclusions.

However, considering the disclosures in their entirety, the district court did find liability for material omissions, particularly for the defendants' failure to disclose the existence of the "control group," and the informal, long-range plan of the control group to acquire a majority of Poulsbo-Telephone stock and build the company into a marketable entity. We agree.

Clearly, a "group" was formed to acquire control of Poulsbo Telephone. Equally clear is the fact that while Serwold appeared as owner of record of 56% of Poulsbo Telephone stock at the time of the sale, its beneficial ownership was divided among members of the "group."

The existence of a plan to acquire control of Poulsbo Telephone, strengthen and sell it is supported by the facts that the control group set out to acquire a majority of the stock; they ceased affirmative efforts to acquire stock after achieving control; they set out on a plan of modernization; they entertained "feelers" from and negotiated with potential purchasers of the company; and they eventually sold it for a substantial gain.

We find more than sufficient evidence to sustain the district court's findings of the existence of the control group and its long range plan. We also agree with the district court's conclusion that knowledge of these facts would have influenced a reasonable investor's conduct.

Defendants assert that the relationship between the attorneys representing the plaintiff and themselves was "casual." They so characterize it to justify their failure

to disclose the existence of the "group," its long range objective to sell Poulsbo Telephone, and any additional financial information. Their position is not well taken. Korth, in his initial letter to Poulsbo Telephone, which Coie answered, requested information as to the "status" of the stock. "Status" suggests more detailed financial information than the general response "[W]e . . . may be in a position to offer $5.00 per share," especially in light of defendants' subsequent knowledge that the plaintiff erroneously assumed that $5.00 represented the fair market value of the stock. Even if Coie ignored the ramifications of Korth's use of "status," he could not ignore Korth's reliance on the $5.00 per share figure as its fair market value for his recommendations to the plaintiff.[1]

We agree with the district court's findings that the omissions, considered in their entirety, but with particular reference to nondisclosure of the control group and its long-range plan are material within the meaning of Rule 10b-5.

Scienter

The district court relied on *White v. Abrams*, 495 F.2d 724, 730, 734 (9th Cir. 1974), which rejected "scienter or any other discussion of state of mind as a necessary and separate element of a 10b-5 action." It also relied on *Myzel v. Fields*, 386 F.2d 718, 734, 747 (9th Cir. 1967), *cert. denied*, 390 U.S. 951 (1968), to support its finding of Rule

1. It is strange that Serwold accepted a letter, addressed to the company of which he was president, from a stockholder inquiring as to the status of the stock, but did not respond in his capacity as a corporate officer. Nor did he have a representative of the company respond. Instead, he turned the letter over to Coie, a control group member and personal friend who at the time represented Serwold personally but did not represent the company. Then Serwold, in his personal capacity, offered to purchase and did purchase the shares from plaintiff with personal checks transmitted through Coie.

10b-5 liability without a showing of scienter.

After the district court's decision, however, the Supreme Court held that negligence is an insufficient basis for Rule 10b-5 liability. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185 (1976). In rejecting negligence as a sufficient basis, the Court stated that some form of scienter was required.

Although it initially defined scienter as a "mental state embracing intent to deceive, manipulate, or defraud," *id.* at 193-94, the Court expressly limited that definition to the case before it. *Id.* at 193-94 n. 12. It recognized that "[i]n certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act." *Id.* In doing so it expressly refused to consider whether "reckless behavior is sufficient for civil liability under § 10(b) and Rule 10b-5." *Id.* Its succeeding terminology, analysis, and citation to authority, however, lend credence to a broad interpretation of scienter. Bucklo, *The Supreme Court Attempts to Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder,* 29 Stan. L. Rev. 213, 218 (1977).

In his analysis of statutory language, Justice Powell apparently accepted a knowledge standard, concluding that the language "strongly suggest[s] that § 10(b) was intended to proscribe *knowing* or intentional misconduct." *Ernst & Ernst,* 425 U.S. at 197 (emphasis added). Also, the Securities & Exchange Commission's argument that "Congress must have intended to bar all such practices and not just those done *knowingly* or intentionally" strongly suggests that section 10b was intended, at a minimum, to proscribe knowing or intentional wrongdoing. *Id.* at 198 (emphasis added). In addition, we note that the Court

cites no cases or commentaries indicating a requirement of strict common law intent. Bucklo, *supra* at 219 n. 30.

Although the Supreme Court left undecided the question whether recklessness is sufficient to support liability under Rule 10b-5, distinguished jurists have long considered it so. *SEC v. Texas Gulf Sulphur Co.,* 401 F.2d 833, 868 (2nd Cir. 1968) (en banc), (Friendly, J., concurring), *cert. denied,* 394 U.S. 976 (1969); *Kohn v. American Metal Climax, Inc.,* 458 F.2d 255, 270 (3rd Cir.) (Adams, J., concurring and dissenting), *cert. denied,* 409 U.S. 874 (1972). *See also* Loss, *Summary Remarks,* 30 Bus. Law. 163, 165-66 (Special Issue 1975) (commenting on *White v. Abrahms*). And since *Ernst & Ernst,* courts have continued to assess Rule 10b-5 liability for reckless behavior. *Bailey v. Meister Brau, Inc.,* 535 F.2d 982, 993 (7th Cir. 1976); *McLean v. Alexander* [Current] Fed. Sec. L. Rep. (CCH) ¶ 95,725, at 99,553 (D. Del. 1976).

Ernst & Ernst, we think, only went so far as to eliminate negligence as a basis for liability. We agree with those courts which have found that Congress intended the ambit of § 10(b) to reach a broad category of behavior, including knowing or reckless conduct.

The district court, operating without the benefit of *Ernst & Ernst,* found the nondisclosures of the defendants amounted to omissions prohibited by Rule 10b-5. It also stated, however, that the evidence did not justify a finding that the defendants "deliberately and coldbloodedly set out to conceal information which 10b-5 requires to be provided." The language "deliberately and cold-bloodedly" suggests willfulness or a particularly aggravated intent.

The question remains whether the lower court found the

defendants merely negligent, or whether it found their conduct more culpable than mere negligence, yet short of willful intent to defraud. Keeton, *Fraud: The Necessity of an Intent to Deceive*, 5 U.C.L.A. L. Rev. 585 (1958). The fact that the district judge never used the word "negligence," or any of its derivatives, in any of his findings of fact, conclusions of law, or opinions tends to indicate that he did not base his decision on a negligence theory.

The district court had sufficient evidence to find liability. It appears that the defendants' omissions were, at the very least, with knowledge. *Lanza v. Drexel & Co.*, 479 F.2d 1277 (2nd Cir. 1973). They knew of the control group, the outstanding, but still indefinite, plans to sell after construction and improvement had conferred added value, and the steady and significant increases in earnings and book value in the few years between the seller's first inquiry and the ultimate sale of the 36 shares.

Knowledge of plaintiff's assumption that $5.00 per share represented the fair market value of the stock was imputable to the defendants because of the statements of their personal attorney. Alternatively, the district court could have found Coie reckless in his evaluation of the "status" of the stock, and imputed that recklessness to the defendants. The evidence supports a finding of recklessness, or some degree of intent not sufficiently aggravated to be characterized as "deliberate and cold-blooded." That would also be consistent with the district court's findings.

II. DAMAGES.

Having found an absence of "scienter" (*i.e.*, "deliberate and cold-blooded intent"), the district court based damages on the highest value for the shares as of December

31, 1967, which it concluded was a reasonable time after the transaction. The court awarded $3,003.48 ($83.43 per share) plus interest and costs. We believe the district court erred in its choice of the theory upon which it computed damages.

Although there is no express enumeration of remedies under Rule 10b-5, it is clear that a plaintiff may sue for money damages. Because few cases have gone to final judgment, the law in this area is still in a formative, somewhat confused state. The early cases generally awarded the difference between the value given and the value received, but the recent trend looks to defendant's profits, rather than to plaintiff's losses, in measuring damages. R. W. Jennings & H. Marsh, Jr., Securities Regulation 1085-88 (4th ed. 1977).

For example, in *Janigan v. Taylor*, 344 F.2d 781 (1st Cir. 1965), the court included in damages the profits realized by insiders in the form of accretion. Similarly, in *Myzel v. Fields*, 386 F.2d 718 (1967), *cert. denied*, 390 U.S. 951 (1968), the Eighth Circuit, relying on *Janigan*, dismissed a defendant's argument that an instruction to the jury permitting an award on the basis of defendant's gain rather than plaintiff's loss violated § 28(a)'s command that only actual damages be recoverable.[2]

---

2. Defendants claim *Myzel* cannot be authority for applying the disgorgement theory, because that court gave an instruction referring to "reasonable period after the fraudulent transaction." The actual instruction, however, provided:

> What constitutes a reasonable period is for you to determine upon all the facts of this case. You should bear in mind that the statute is not intended to provide investors with an insurance policy against market changes. *It does, however, seek to prevent those who have engaged in fraudulent or illegal conduct from benefiting by that conduct.*

386 F.2d 745 n. 23 (emphasis added).

The Supreme Court, relying on *Janigan* and *Myzel*, stated the rule for the measure of damages for defrauded sellers in *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 155:

> In our view, the correct measure of damages under section 28 of the Act . . . is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no fraudulent conduct . . . *except for the situation where the defendant received more than the seller's actual loss. In the latter case damages are the amount of the defendant's profit.* (Emphasis added.)

This rule provides full compensation for injury caused by fraudulent conduct, and, significantly, it removes all incentive to engage in such conduct.[3] It results in the "simple equity that a wrongdoer should disgorge his fraudulent enrichment." *Janigan v. Taylor*, 344 F.2d at 786. The instant case falls within the rule of *Affiliated Ute Citizens:* because the defendant's gain is greater than the seller's loss,[4] damages are the amount of the defendant's profit.[5]

---

3. The only possible exception to this rule, noted in *Janigan* upon which the Court relied, is a subsequent increase in the value of the stock attributable to special or unique efforts of the fraudulent party other than those for which he is duly compensated.

The record, however, fails to show the accretion in Poulsbo Telephone stock values was caused by defendants' "extraordinary contributions." Serwold was a director and president of the company, and his wife was a director. To the degree they did modernize Poulsbo Telephone and effect the sale, they were acting in their compensated corporate capacities.

4. Defendant's profit was roughly $495 per share ($500 worth of United stock received less their cost of $5 per share of Poulsbo Telephone), as opposed to plaintiff's loss at the time of the transaction, which was approximately $55 per share ($60 book value less $5 received).

5. Although we conclude this case clearly falls within the exception to the *Affiliated Ute Citizens* rule, we also believe the result follows from the general rule of the case. Had there been no fraudulent conduct, the

Defendants strenuously argue that the disgorgement theory is harsh and applicable only to instances of conscious, affirmative misrepresentations as opposed to mere omissions, as in this case. They argue that to award profits accrued over such a long time makes the fraudulent buyer an insurer against adverse market fluctuations. We are not persuaded.

First, we see no harshness in a remedy which takes from a fraudulent actor what was generated by his conduct. *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1976) (Sneed, J., concurring); *Myzel v. Fields*, 386 F.2d 718, 747; *Janigan v. Taylor*, 344 F.2d 781, 786. To allow violators of the Act to profit by their misconduct would undermine the deterrence that the Act was intended to effect.

Secondly, the remedial section, 28(a), does not distinguish between misrepresentations by affirmation and omission. There is no logical basis for such a distinction. This is especially so in the context of the overall statutory scheme of full disclosure. Either kind of misrepresentation is a means by which one can defraud another, and an omission can be as intentional as an affirmation.

Finally, we find that to refuse to award all of the accretion in value through the date of the discovery of the fraud

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evidence could support a finding that plaintiff would not have sold the Poulsbo Telephone stock until the company was sold to United. Treating the shares as "historical curiosities," the administrator kept them in a safe deposit box. Absent the April 15, 1965, letter from Coie, it is likely the certificate would have remained in the Wisconsin safe deposit box until the sale to United. Hence, had there been no fraudulent conduct, the plaintiff would have received stock in United valued at $500 per share of Poulsbo Telephone, rather than the $5 per share that he received in the fraudulent exchange. The circumstances would seem to justify awarding any accretions in value through the date of the sale to United.

would reward those who conceal their misconduct. We agree with *Janigan v. Taylor*, 344 F.2d at 786, that "[i]t is more appropriate to give the defrauded party the benefit even of windfalls than to let the fraudulent party keep them."

Judge Sneed recently articulated the theoretical model underlying the disgorgement theory. *Green v. Occidental Petroleum Corp.*, 541 F.2d 1335, 1342 (9th Cir. 1976) (concurring opinion). He explained:

> [T]he rescissory measure of damages . . . in theory . . . contemplates a return of the injured party to the position he occupied before he was induced by wrongful conduct to enter the transaction. Assuming a sale and purchase of stock, true rescission would involve a return, on the one hand, of the purchase price and, on the other, of the stock purchased. In many instances, however, the purchaser no longer possesses the stock when rescission is sought. Under those circumstances only the monetary equivalent of the stock can be returned.
>
> To adhere to the model of rescission the monetary equivalent should be determined as of the date the purchaser was under a present duty to return the stock, *viz.* the day of judgment. *See* Note, The Measure of Damages in Rule 10b-5 Cases Involving Actively Traded Securities, 26 STAN. L. REV. 371, 372 (1974). The courts generally, however, do not use the date of judgment but employ an earlier post-transaction date, such as the date of disclosure of the fraud. *Id.*
>
> This measure [purchase price less value at the time of disclosure] works justly when a defrauded *seller* proceeds after an *increase* in value of the stock against a fraudulent buyer who is unable to return the stock he fraudulently purchased. His inability to return the stock should not deprive the injured seller of the remedy of restitution. Under these circumstances it is appropriate to require the fraudulent buyer to account for his "ill-gotten profits" derived from an increase in the value of the stock following his acquisition of the stock. *See* Janigan v. Taylor, 344 F.2d 781 (1st Cir. 1965). *See also* Affiliated Ute Citizens v. United States, 406 U.S. 128 (1972). Only in this manner can the seller be put in the position he occupied before the contract was made. *Cf.* Corbin on Contracts, § 1112 (1964).

The sale of Poulsbo Telephone's assets to United precipitated the discovery of the fraud and it is reasonable to fix that as the date of discovery. Plaintiff should be awarded defendants' profits derived from the sale to United.

We reverse and remand for a determination of damages consistent with this opinion.

APPENDIX F

IN THE UNITED STATES COURT OF APPEALS
FOR THE NINTH CIRCUIT

KENNETH N. NELSON, *Plaintiff-Appellant,* v. O. E. SERWOLD and HELEN SERWOLD, his wife, *Defendants-Appellees.*	No. 76-1001
KENNETH N. NELSON, *Plaintiff-Appellee,* v. O. E. SERWOLD and HELEN SERWOLD, his wife, *Defendants-Appellants.*	No. 75-3833

ORDER

FILED JUNE 26,1978
EMIL E. MELFI, JR., *Clerk*
U.S. Court of Appeals

Before: KOELSCH and WRIGHT, Circuit Judges, and CALLISTER, District Judge.

The panel has considered the Petition for Rehearing En Banc, and the Answer to the Petition for Rehearing En Banc. Judge Wright has voted to reject the en banc suggestion.

The full court has been advised of the en banc suggestion, and no judge of the court has requested a vote on it. Fed. R. App. P. 35(b).

The Petition for Rehearing En Banc is rejected.

Supreme Court, U. S.
FILED
OCT 19 1978
MICHAEL RODAK, JR., CLERK

IN THE

Supreme Court of the United States

October Term, 1978

No. 78-182

O. E. SERWOLD and HELEN SERWOLD, his wife,
Defendants-Petitioners,

v.

KENNETH N. NELSON,
Plaintiff-Respondent.

BRIEF IN OPPOSITION

TO

PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

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I N T H E
SUPREME COURT OF THE UNITED STATES

October Term, 1978

No. 78-182

O.E. SERWOLD and HELEN SERWOLD, his wife,
Defendants-Petitioners,

v.

KENNETH N. NELSON,
Plaintiff-Respondent.

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE NINTH CIRCUIT

WHY THE CAUSE SHOULD NOT BE REVIEWED

The Ninth Circuit Court of Appeals' Opinion in this cause should not be reviewed by this court because:

1. The Opinion is correct in all of its respects, save for its agreement with the District

Court that Coie's affirmative misrepresentations were not material, a conclusion favorable to defendants-petitioners;

2. The district judge did not, as petitioners claim, find that defendants "acted without 'scienter,'" as properly defined, and that their conduct was not "knowing," nor did he find but a mere "technical violation" of Rule 10b-5. He categorically defined "scienter" as "deliberate and cold-blooded" concealment of material facts (R. 314, 366). He refused to find defendants' omissions "occurred knowingly in the 'scienter' sense," i.e. knowingly in the sense of being "deliberate and cold-

blooded." He spoke of a "lack of deliberate and wilful fraud in this case" (R. 352) and of his belief that defendants did not "wilfully and deliberately set out to conceal information" (R. 351). Unconcerned with scienter, except for purposes of rejecting restitution ("constructive trust"), because the "fraud" was not "relatively severe" (R. 351), the district judge did not make any finding of ultimate fact concerning any degree of culpability less stringent than intent to deceive. Recognizing that knowing misrepresentations or omissions, irrespective of intent, as well as recklessness, suffice for "scienter," the Ninth Circuit prop-

erly inferred from the circumstantial facts found by the District Court that defendants' conduct at least fell within such lesser degrees of culpability;

3. The district judge had no "equitable discretion" to adopt an erroneous measure of damages and apply thereto a hodgepodge of erroneous notions enumerated on page 3 of the petition;

4. The decision is not upon a unique question of federal law, but is in accord with applicable decisions of this Court and is not in conflict with any decision of another court of appeals on the same or similar matter; and

5. The federal issues are rendered moot by the District

Court's finding of violation of the Washington counterpart to Securities Exchange Commission Rule 10b-5, RCW 21.20.010 (1959), and by the Washington legislature's retrospective amendment of the Civil Liabilities section of the Washington Securities Act, wo-wit: RCW 21.20.430(2) [1977] creating strict civil liability for "violation" of RCW 21.20.010, and defining "damages" for purchaser fraud as

> the value of the security when the buyer disposed of it, and any income received on the security, less the consideration received for the security, plus interest at eight percent per annum from the date of disposition, costs, and reasonable attorneys' fees,

precisely, except for addition of reasonable attorneys' fees, the correct federal measure.

COUNTER-STATEMENT OF THE CASE

A Case of Agreed Facts

Almost all of the essential facts of the case are admitted and are set forth separately, and are enumerated, in the Pretrial Order (R. 268, 269-281). There exists no conflicting or ambiguous testimony. The entirety of the fraudulent securities transaction, in its every aspect, was carried on exclusively by use of the United States mails directly between defendants' Seattle attorney, J. Paul Coie (Coie), and plaintiff's Rhinelander, Wisconsin, attorney, Earl A. Korth (Korth), except the initial communication, Ex. "A" (R. 24), was mailed from Korth to Poulsbo Rural Telephone Association (PRTA). (R. 270-71, 360-61.)

On September 26, 1975, 507 days after the allotted one-day trial to the court, the District Court judge, prompted by plaintiff having filed in the

Court of Appeals (No. 75-2850) his Petition For Writ of Mandamus requesting the district judge be required to forthwith enter findings of fact, conclusions of law and judgment, signed Findings and Conclusions, "finding" twenty-five of forty-five admitted facts, fashioning one of his own (FF 27, R. 365), and adopting three proposed by defendants (FF 26, 28 and 29, R. 365-6).

Background

Like Chinese boxes, one within another, the securities fraud was within an older and more extensive scheme of corporate mismanagement. In the beginning, about the year 1956, defendant O. E. Serwold (Serwold) discovered that insurance company financing was finally available to effect modernization of PRTA's extremely antiquated telephone system (Tr. 0030, 0032-33). Defendants, Rudie and Evelyn Iversen, W. H. Gee and

Coie (the control group) decided to attempt to acquire in Serwold's name (Tr. 0047) all (Ex. "NN") of PRTA's outstanding stock (Tr. 0029-30). Their plan was to at least acquire control, modernize the telephone system, convert the company to a marketable enterprise and then sell it to an independent company (FF 27, R. 365, Tr. 0049). The control group members entered into a continuing agreement by which all of the PRTA stock owned of record, or which might in the future be acquired by any of them, was beneficially owned approximately 30% by the Serwolds, 30% by the Iversens, 30% by Gee and 10% by Coie [AF (Admitted Fact, Pretrial Order) 2.23, R. 274-5, partly adopted as FF 23, R. 363]. The agreement was a carefully-kept secret. It was never disclosed to PRTA's 150 shareholders (R. 359) not members of the control group, nor was the same ever reported to the Washington Utilities and

Transportation Commission, and, of course, no disclosure of the existence of the control group or of its plan to sell the company was ever made to Korth or to his clients, the Nelson family (AF 2.23, R. 274-5, c.f. FF 23 and 27, R. 363, 365). By 1959 the secret control group had acquired about 55% of PRTA's outstanding stock, all placed in Serwold's name (Tr. 0030, 0047, cf. Tr. 0011-12, 54% acquired in 1956).

Serwold was made PRTA's $24,000 per year president in 1957 and at all times he and his wife were PRTA directors (FF 8 and 9, R. 359-60; AF 2.8 and 2.9, R. 269). Their son, Roger, was a salaried PRTA employee (AF 2.28, R. 276-7). By 1971 Serwold's and Roger's salaries had progressively increased to $36,000 and $18,000, respectively (Id.). Under these comfortable circumstances, the nurtured facade of Serwold owning a majority of PRTA's stock naturally dis-

couraged any speculation that the seeming family enterprise would ever be sold. Just as naturally, despairing, uninformed stockholders would from time to time sell their shares to Serwold for his fixed price of $8.00 per share (Tr. 0031-37, 0098, Ex. "NN"). Had the existence of the control group and the diverse ownership of the control stock been disclosed, at least sophisticated shareholders might have discerned a probability of sale, judging from the advanced age of the control group members, the fact that only Serwold had a child active in the business, and the realities of estate planning with respect to unmarketed, close corporation stock.

Perjurious denials of the existence of any control group were persistently made in Annual Reports to the Washington Utilities and Transportation Commission. (See, i.e., Ex. 4, Annual Report to

Comn., December 31, 1964, p. 2, Serwold's answers to queries 2 and 3 denying as "not applicable" the existence of any control group, and p. 5, query 2, eliciting the names and addresses of each person having a beneficial interest in defendant's PRTA stock, such query not answered. All such Annual Reports were uniform with respect to such denials and nondisclosure.)[1]

When the control group acquired control of PRTA, they soon, to paraphrase Churchill, "rang down an iron curtain" upon the company's internal affairs. The flow of information to out-

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[1]Serwold also falsely certified, annually, that PRTA had no contract or lease with "any affiliated interest" (i.e., a beneficial owner of 5% or more of PRTA's stock (RCW 80.16.010)) such as W. H. Gee, a member of the secret control group. In 1957, Gee constructed a modern telephone building and leased it to PRTA for a term of twenty years. He purchased the land from fellow-control group members Rudie and Evelyn Iversen. Nondisclosure of Gee's affiliation circumvented obtaining regulatory agency approval of the lease, though a statute declares such a lease invalid in the absence of Commission approval. RCW 80.16.020.

sider stockholders ceased. All outsiders were ousted from management. (Ex. "00", Tr. 0015-18.) PRTA's stockholders were not treated to meetings from February 1959 through 1965 nor, in the years 1960-1970, inclusive, to any PRTA financial statement, newsletter or narrative progress report (AF 2.24, 2.25 and 2.26).

By the time of Coie's 1965 solicitation of the Nelson family's PRTA stock, there was nothing "long range" (cf. FF 27, R. 365) about the control group's plan to sell the company. As was established against defendants on remand in Lanning v. Serwold, et al., 474 F.2d 716 (9th Cir. 1973), before District Court Judge George H. Boldt, USDC WD WASH. No. 9525, on 8/26/74, appeal dismissed 4/1/75, Ct. App. No. 74-3405: ". . . There had been, however, during a period of four years immediately preceding

June, 1970, active soliciations by O. E. Serwold and some responses and inquiries by representatives of independent telephone companies respecting sale or merger of PRTA, . . ." (R. 346-47, 350 (Judge Boldt's FF 32)).

In a third case PRTA's attorney, Conrad Greeen, in June, 1970, advised the District Court: "The fact of the matter is that there have been discussions and negotiations for the past three or four years regarding the attempted sale of this Company (PRTA)" (Ex. "HH"). Serwold testified he didn't know where Green got his information (Tr. 0104-5).

The Fraud

On October 17, 1962, Korth wrote to PRTA advising that he had found in his Estate of Nels Nelson, Deceased, file PRTA's stock certificate No. 305 for 36 shares issued in 1911 to R. Norman (Ex.

"A"; R. 24; AF 2.12, R.270; FF 13, R.360; Korth Dep. p. 7). Korth requested: "(Please) . . . advise me of the status of this stock" (Id.).

Serwold, as PRTA's president, received the letter and delivered it to Coie, who was not PRTA's counsel (Tr. 0055-56), but was Serwold's "personal attorney" (Tr. 0019-20). Indicatively, Serwold did not refer the letter to PRTA's counsel, Niemeier, Green & Root, who officed in Poulsbo (Tr. 0020). Mr. Root was routinely consulted on corporate matters (Tr. 0016, 0030).

On December 11, 1962, writing under the letterhead of his large Seattle law firm, Coie wrote Korth: "Your letter . . . has been referred to us for reply. . . . If you can furnish us satisfactory evidence of present ownership, we then may be in a position to offer $5.00 per share" (Exs. "B", "B-1"). Though soliciting an insider purchase, Coie felt no obligation of disclosure (Tr. 0057). His explanation for offering such a low price, was "risk of clouded title" (Tr. 0057), yet his offer was expressly conditioned upon Korth furnishing "satisfactory evidence of present ownership" (Exs. "B", "B-1").

Korth, assuming Coie represented PRTA (Korth Dep., p. 11), wrote to Coie on January 22, 1963, showing ownership in the Nelson estate and inquiring whether "any dividends . . . are accrued" (Ex. "C"). There was no response for 27 months, during which time the Nelson estate was closed (Tr. 0078, Ex. "N"), the administrator retaining the PRTA certificate in his safety deposit box (Tr. 0078) "as a souvenir" (Tr. 0081).

The Nelson family was advised by Korth that there wasn't "enough value in the stock to cover (attorneys') fees"

for obtaining registration of transfer of the stock from R. Norman, who was deceased (Tr. 0077-78). Neither plaintiff nor his brother had ever bought or sold stocks or bonds (Tr. 0074-75).

Abruptly, on April 15, 1965, Coie wrote Korth:

> . . . If you will give us an affidavit (of ownership) and surrender Certificate #305 for 36 shares of (PRTA), the enclosed check of O. E. Serwold . . . in the sum of $180.00 may be cashed.
>
> There have been no dividends ever declared since the formation of this company, and none can be anticipated for years because of mortgage commitments required to finance capital improvements. This is a regulated utility and there has never been a surplus from which dividends could have been declared.

(Ex. "D".) The drawer of the check (Serwold) was never identified other than by his initials and surname. The letter (Ex. "D") indicated to Korth that PRTA was probably in "quite precarious" financial condition. (Korth Dep., p.

49.) Korth assumed $180 represented the fair market value of the 36 shares (Korth Dep., p. 21) and so advised Coie, as well as plaintiff's brother, Herbert Nilsson (Nelson), the administrator (Ex. "E", note "cc: Mr. J. Paul Coie"; see AF 2.12, R. 270; FF 13, R. 360-61). Coie chose to remain silent. Nilsson wrote to his cousin, Wilma Lowry of Seattle, who was related by marriage to R. (Richard) Norman, requesting she learn what she could about PRTA (Ex. "Y", Tr. 0067-68). She responded but was unable to give Nilsson any information (Tr. 68).

On July 9, 1965, Korth, then age 68 (Korth Dep., p. 3), and whose total fees in the matter were $35 (Ex. "K"), wrote to Coie inquiring "whether or not Mr. Serwold would be willing to pay $250 for the stock" (Ex. "F"). The requested price increase was inspired by Korth's

concept of "horse trading" (Tr. 0080). Instinctively, Coie knew Korth wanted "to get a little money for his services" (Tr. 0057). Coie promptly accepted, forwarding another Serwold check for the additional $70 (Ex. "FF-1").

After some delays of which Korth kept Coie apprised (Exs. "G" & "GG-1), Korth on September 16, 1965, mailed to Coie PRTA's stock certificate No. 305 (Ex. "J") and Nilsson's affidavit of heirship (Ex. "I") tracing ownership of the certificate to the Nelson estate. The certificate was endorsed to "O. E. Serwold" by "Herbert Nilsson, Administrator WWA of the estate of Nels Nelson", and by agreement was "dated back to May 1, 1963, when Nilsson was Administrator" (Ex. "J"; Agreement: Exs. "F", "FF-1" and "H").

On September 20, 1965, Coie wrote to defendant: "At long last I think we

have acquired Norman's shares. . ." (Ex. "M", emphasis supplied). Serwold effected registration of transfer of the certificate to himself as a purchaser for value and did not advise PRTA of any fact which might have impaired the validity of the assignment or transfer to him (AF 2.39, R. 280).

The Affirmative Misrepresentations

As found by the District Court, Coie's initial letter (Ex. "B") suggested the value of the stock was only $5.00 per share.

> He (Korth) would not be likely to be making extensive inquiries concerning 36 shares of an undistinguished rural telephone company half way across the country. This is particularly true where the original correspondence suggested a value of only $5.00 a share. . . . (DC Opinion, R. 309, 312, expressly adopted as a finding of fact, FF p. 2, R. 358.)

At the time of Coie's letter (Ex. "B"), the book value per share was $37.20 (AF

2.32, R. 278)[2], and the stock had earned for the past year $3.43 per share (Ibid). Earnings were to almost double in the next year, 1963 (Id.).

When Coie foisted Serwold's unsolicited purchase-money check upon Korth, he advised: ". . . there has never been a surplus from which dividends could have been declared." (Ex. "D".) Both the statement and its implication that the company had never been profitable were false. On June 30, 1956, more than three years before imposition of

[2]The "Book Value Per Share" figures are inadvertently stated $1 less than actual, the mistake arising from failure of counsel to add to "Retained Earnings & Surplus" the company's outstanding capital stock, $7,123, being 7,123 shares outstanding times $1 per share each, thereby understating Stockholders' Equity by $1 per share. For example, "Book Value Per Share" on December 31, 1962, is stated at $36.20 instead of $37.20. Cf. R. 49.

the contractual dividend restriction (FF 21, R. 362), PRTA had "unappropriated earned surplus" of $98,924.55 (Ex. "SS"; see Motion to Reopen Hearing Solely To Permit Admission Of Exhibit, R. 265-7; motion granted Tr. 0130). The entire sum was available for declaration of dividends and remained so until October 21, 1959, when dividends were voluntarily restricted by a covenant contained in a mortgage of that date (FF 21, R.362). The District Court did not find Coie's statement to be true, but only that it was not a material misrepresentation (DC Opinion, p. 1, R. 309, FF 26, R. 365).

The sway of the contractual "dividend restriction" (FF 21, R. 362) contained in the mortgage was more contrived than real. PRTA easily met the minimum capital and surplus requirement as well as the mortgage-debt-to-plant ratio

(Ex. "T"). Only its current ratio, as reported at year-end, was deficient. This was because a large long-term bank debt in the form of a ninety-day bank loan continuously rolled over, was presented as a current liability under "Accounts Payable" (Tr. 0127). Also, PRTA was not extravagant in statement presentation of its year-end accounts receivable. Exhibit "T" peculiarly shows such accounts ("Due from customers and agents") at a mere 1/40th of annual "Operating Revenues", or only a small fraction of an average month's revenue. Apparently, we are to believe Poulsbo's citizens do not use the telephone at Christmas time. Serwold offered no reason why PRTA's current ratio could not have been easily improved to the required 1:1 or better by modest refinancing, switching some current debt to long-term debt PRTA's total debt was less than 45% of its assets (Ex. "T").

The Company's CPA was unable to explain why year-end accounts receivable were disproportionate to an average month's revenue but admitted that telephone companies "show a low profile" in their financial reports to the Utilities Commission (Tr. 0125-126).

Four months after Serwold and Coie relieved the Nelson family of its stock, PRTA met all conditions on payment of dividends; it borrowed long-term "for purpose of capital expansion" (cf. "Dividend Restriction", R. 362) $80,000 under terms requiring almost interest-only payments for twenty years (FF 22, R. 363). The loan, like the profit sharing plan, infra, was planned well before the fraud (Exs. "JJ" and "KK"; see "MM").

Coie's statement that "no dividends . . . can be anticipated for years" (Ex. "D") was not supported by any resolution of the Board of Directors to that effect

(AF 2.36, R. 280). Coie implied PRTA could not pay dividends while the truth was simply that the control group did not choose to do so. An annual dividend of $1 per share would have cost PRTA $7,123 per year (FF 7, R. 359). In February 1966, as a mark of its increasing affluence, and in contrast to Coie's despairing report to Korth (Ex. "D"), PRTA adopted a profit sharing plan to which it contributed in the years 1966-1971 $185,523.23.

That PRTA was "a regulated utility" (Ex. "D") did not preclude it from being highly profitable. PRTA's after-tax net income in 1965 was 14% of its operating revenues and this profit ratio rose to 20% in 1971 (Exs. "T" and "U").

The Non-Disclosures

Coie did not disclose the existence of the control group (AF 2.23, R. 274-5), nor, of course, that he was a

member thereof and stood to acquire a 10% beneficial interest in the stock he was soliciting (AF 2.23, R. 274-75), nor that Serwold was the chairman of the board and president of PRTA and its majority stockholder. Feigning an attorney relationship with PRTA (Ex. "B"), Coie masked his true capacity as Serwold's attorney. He did not disclose the intent of the control group to build up the company and sell it (FF 27, R. 365), nor that Serwold would soon in 1966 commence active solicitations respecting sale or merger of PRTA (FF 32 in Lanning v. Serwold, R. 346-47, 350, cf. Tr. 104-107, Ex. "HH").

Though Korth requested the "status" of the stock (Ex. "A"), Coie furnished no financial information, except to falsely imply by his offer that $5.00 per share was the fair value of the stock (Ex. "B"). When thirty months la-

ter Coie resumed his solicitation, he made no disclosure of PRTA's substantial progress during that hiatus, but instead submitted a despairing and misleading statement of PRTA's ability to pay dividends and a false statement respecting its surplus (Ex. "D").

During the Hiatus, in the years 1963 and 1964, PRTA added $12.15 per share to its "surplus" (retained earnings) and in 1965 was on its way to adding thereto a further $7.31 per share (AF 2.32, R. 278). From a year-end 1962 book value of $37.20 per share, such value climbed to $60.10 at year end 1965 and was destined to reach $164.42 at year-end 1971 (Id., R. 278-79; n. 1, supra).

In 1965 the company's operating revenues were 175% above its 1962 operating revenues, and its net profit was 227% above its 1962 performance (AF

2.31, R. 277-78). PRTA's retained earnings reached $420,951 in 1965, equivalent to $59.10 per share (AF 2.32, R. 278), 63% more than in 1962 when Coie first offered $5.00 per share (Ex. "B"). In 1965 prior to consumation of the securities transaction, PRTA added direct distance dialing and automatic ticketing to its plant facilities, installed a new submarine cable and was completing upgrade of its service to five parties or less on a line (AF 2.33, R. 279). Aside from its modernization, the company was blessed with steady growth (Id.) and had become, in early 1965, a marketable entity, in itself an explanation for Coie's abrupt resolicitation of the Nelson family's stock (Ex. "D"). Coie testified he didn't know what "triggered" him, after a lapse of 28 months, to write Exhibit "D" (Tr. 0043).

In January, 1972, PRTA sold substantially all of its assets, receiving stock of United Utilities, Inc., now called United Telecommunications, Inc. (United), traded NYSE, which PRTA exchanged 25 for 1 in redemption of its shares, a value of $500 for each PRTA share (Exs. FF, pp. 3, 13-14, A-9, GG).

ARGUMENT

Rule 10b-5 Liability

Coie's vicarious acts and omissions closely parallel the incident which 35 years ago caused, in a single day, Rule 10b-5 to be both drafted and promulgated. See Lanza v. Drexel & Co., 479 F.2d 1277, 1290 n. 32 (2nd Cir. 1973). The essence of the Rule, and one of the primary purposes of the entire 1934 Act, is to outlaw the use of inside information by corporate officers and principal stockholders for their own financial ad-

vantage to the detriment of uninformed public security holders (Id. p. 128990).

Though "scienter" is essential to the imposition of liability, that many-faceted concept broadly encompasses intent to deceive or defraud, knowing misstatement or omission of fact irrespective of intent, and reckless disregard for the truth (Id. p. 1289-90; Bucklo, The Supreme Court Attempts To Define Scienter Under Rule 10b-5: Ernst & Ernst v. Hochfelder, 29 Stan. L. Rev. 213, 214 (1977)). As noted in the Opinion, 576 F.2d at 1337, "defendants' omissions were, at the very least, with knowledge," a more stringent standard of culpability than recklessness, with which defendants would have this Court deal and which, being on the less strict end of the scienter spectrum, was expressly reserved in Ernst & Ernst v. Hochfelder, 425 U.S. 185 at 193-94 n. 12, 47 L. Ed. 2d 668, 677 (1976).

In Ernst & Ernst, this Court stated the issue to be "whether scienter is a necessary element of a (10b-5) action, or whether negligent conduct alone is sufficient" (425 U.S. at 197)--a suggestion that the holding does no more than reject negligence. Deciding intent, expressly limited to the case (425 U.S. at 193-94, n. 12), and reserving recklessness, this Court apparently accepted a knowledge standard (Id. at 197). Indeed, at the close of the section on 10b-5 liability, Justice Powell concludes merely that: "We are quite unwilling to extend the scope of the statute to negligent conduct" (425 U.S. at 214). None of the cases or commentaries cited in the case as favoring a scienter requirement indicates that strict common-law intent to deceive is a necessary part of that requirement. The modern common law of fraud is that knowing mis-

statements, irrespective of intent, suffice for scienter. Even the English common law allows liability when the representation is "made (1) knowingly or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false." Derry v. Peek, 14 App. Cas. 337, 374 (1889). For excellent discussion of Ernst & Ernst, see Bucklo, supra, 29 Stan. L. Rev. 213 (1977), and McLean v. Alexander, 420 F.Supp. 1057, 1080 (D. Del. 1976). There appears to be no case rejecting knowledge or recklessness as a sufficient 10b-5 culpability.

The Degree of Defendants' Culpability

Coie's affirmative misrepresentations and nondisclosures betray his state of mind. At the outset, seeking Korth's confidence, Coie feigned a corporate reply (Ex. "B" and "B-1"), knowing Korth would reasonably accept it as

such, which he did (Korth Dep., p. 11). So disguised, defendants and Coie acted as predators, taking gratuitous advantage of Korth's inquiry as to "the status of the stock" (Ex. "A") to solicit purchase of the same for a ridiculously low price--$5.00 per share" (Ex. "B"), knowing Korth and the Nelson family were geographically disadvantaged, and, like most other minority stockholders, had utterly no information upon which to base an investment decision respecting PRTA stock (AF 2.23-2.27, R. 268, 274-76).

The disparity of information and of access to information which existed between Serwold and Nilsson, or between Coie and Korth, could not conceivably be greater in any 10b-5 case. The compelling implication is that defendants and Coie well knew the inherent unfairness involved in the transaction, because

they were taking advantage of a plethora of corporate information, including that held to have been material to the transaction, knowing it was unavailable to Nilsson and Korth. So, too, the unjustified low price creates under the circumstances a rational inference that defendants and Coie knew they were taking undue advantage in the transaction.

Disclosure to a seller of stock that his purchaser is the president and the majority stockholder of the issuer corporation is apt to trigger inquiry, especially if the purchaser initiated the transaction. The same is true as respects disclosure that an attorney, who answers for, and is erroneously believed to represent, the corporation, actually represents a secret control group, of which he is a member, and which is the real purchaser. Conversely, nondisclosure of such relationships,

especially by insider purchasers, implies recognition of the adverse consequence of disclosure and tends to show a knowing or reckless, if not a studied and intentional, omission.

The district judge felt there was no special relationship between Coie and Korth; that they "were simply two lawyers--carrying on what was apparently a routine and rather minimal transaction." (DC Opinion, R. 309 at 311.) Man's naivety is boundless. The special relationship was, of course, that of agent for, and co-principal of, fully-informed corporate insiders[3], vis-a-vis the representative of an utterly uninformed minority stockholder. The rela-

[3]Mrs. Serwold was at all times a director of PRTA (FF9, R. 360).

tionship was fiduciary--that of majority stockholder, president and chairman of the board to minority stockholder. Defendants' duty was not less because they chose to deal through their personal attorney, Coie, who also was an insider and who "stood to acquire, and did acquire, a 10% beneficial interest in the stock." (AF 2.23, R. 274-75.) Plunkett v. Dominick & Dominick, Inc., 414 F. Supp. 885 (D.C. Conn. 1976); Lanza v. Drexel & Co., 479 F.2d 1277, 1293 (2d Cir. 1973). Coie's failure to disclose the identity of his principal and the relationship of the latter to PRTA, as well his failure to disclose the existence of the control group, its members and its plan to build up and sell the company, was either intentional or knowing, defendants and Coie testifying to no inadvertency about these matters. Defendants' initiative in the transac-

tion and Coie's final triumphant statement to Serwold, "at long last I think we have acquired Norman's (plaintiff's) shares" (Ex. "M"), also show that their misrepresentations and nondisclosures were not merely inadvertent without any fraudulent or deceitful intent, but were studied and intentional, to be characterized as a scheme to obtain the stock without giving any information whatsoever as to the true condition of the company or the value of its stock, so as to, in that way, obtain the same at an extreme low price.

Indeed, far from inadvertency, Coie's testimony disclosed a flippant, rather arrogant state of mind:

> Q. Did you search diligently the records of the company before you wrote the letter (Ex. D)?
>
> A. No, I did not. In fact, I didn't search them at all. (Tr. 0045.) [His access to corporate information was carte blanche (Tr. 0055 & 0056).]
>
> . . .

> Q. Why did you not send a financial statement to Mr. Korth?
>
> A. He didn't ask me for one. (Tr. 0054.)
>
> . . .
>
> Q. And you didn't feel, I take it, that you had any obligation to Mr. Korth to investigate those matters or to disclose them to him?
>
> A. Perfect stranger to me. A lawyer is all I knew. (Tr. 0057.)

So, Coie, an able, senior attorney, a writer of proxy statements (Tr. 0051-52, 0056), denied even at the trial defendants' and his own duty of disclosure. If Coie was unfamiliar with the Insider Rule, ingrained in 10b-5 law well before 1962, he did not say so, and if he was, an intentional violation of the rule must be presumed. The district court held:

> This combination (of undisclosed material facts) ought to have made Coie, as a capable and experienced lawyer, aware that Korth must have been relying to rather considerable

> extent on the relationship between himself and Coie in making an investment decision, and in disclosing those things which a seller would be likely to want to know. (DC Opinion, R. 309, 313, incorporated as a finding, FF p. 2, R. 358).

As noted in the Court of Appeals Opinion, 576 F.2d at 1335, Korth expressly indicated to Coie his assumption that the original $180 price was "the value of the stock," stating a second time in the same first paragraph of his letter, "We (Korth) assume it represents the fair market value of the stock." (Ex. "E", letter, Korth to Nilsson, cc: Coie, 4/20/65.) Coie made no disclaimer; he knowingly chose silence, an implicit confirmation of his own suggested value. Coie's refusal to dispel the false notion of value could only be intentional, knowing or reckless.

Coie's gratuitous, false statement to Korth that "there has never been a

surplus from which dividends could have been declared" (Ex. "D") was devastating. Not only was the statement false, but also it falsely implied the company, throughout its 57-year history (FF 5, R. 359) had never been profitable. Naturally, the letter falsely indicated to Korth that PRTA was probably in "quite precarious" financial condition (Korth Dep., p. 49).

Even a statement which is literally true, if reasonably susceptible to quite another interpretation, may properly be considered a material misrepresentation. SEC v. First American Bank & T. Co., 481 F.2d 673, 678 (8th Cir. 1973). A statement may be found misleading in view of the context in which it was made (Id.). It is the impression created by the statements which determines whether they are misleading. Kubik v. Goldfield, 479 F.2d 472, 476, n. 7, (3rd Cir. 1973).

Coie was at least reckless, admitting, in preparing the letter (Ex. "D"), he made no search at all of company records (Tr. 0045). But the letter was more; it was deceptive, cunning and manipulative. Making no mention of PRTA's startling progess during the previous 28 months since his initial and last letter (Ex. "B"), nor since then of the 62% increase in the book value of PRTA's shares, Coie addressed Korth as if no increase in value of the stock had occurred, purveying only despair under a ruse of answering Korth's 27-month-old inquiry whether any dividends were accrued (Ex. "C"). Coie's reference to the company being "a regulated utility" could have been, in context, only intended to impart a notion that the company was permitted only sparing profits, when in truth the company was making excellent profits, measured either as a

percentage of its revenues or return on equity (FF 24, R. 363-64, Ex. "T"). Indeed, in 1971, PRTA earned, and was permitted to earn, a net profit equal to 20% of its operating revenues (Ex. "U"). Serwold received a copy of Coie's letter (Ex. "D", FF 13, R. 360) and must have recognized its inaccuracies and deceptive innuendo.

All of the essential facts are agreed. Defendants have no ground for charging the Ninth Circuit with "usurpation" (Pet., p. 26) because that court concludes, from the findings and/or the agreed facts, "that the defendants' omissions were, at the very least, with knowledge" or, alternatively, were reckless or encompassed "some degree of intent not sufficiently aggravated to be characterized as 'deliberate and cold blooded'"--the district judge's definition of "scienter."

Materiality

As a matter of law, a reasonable man, in making his investment decision, "would attach importance" to a plan to sell the company in which he held stock and for which there was little or no market. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 48 L. Ed. 2d 757 (1976). The control group plan to build up and sell the company may have been "long range" in 1956, but it was not in 1965. By then the build up had largely occurred (AF 2.33, R. 279). Soon in 1966 Serwold was to commence active solicitations respecting sale or merger of PRTA. The timing of his solicitations was resolved adversely to defendants on remand in the earlier case of Lanning v. Serwold, supra, and may not be relitigated. Harris v. Washington, 404 U.S. 55, 56, 30 L. Ed. 2d 212, 215 (1971); Adelt v. Richmond School

District, 476 F.2d 662 (9th Cir. 1973). Equally material would be "the steady and significant increases in earnings and book value in the few years between the opening inquiry and the sale" (DC Opinion, R. 313, adopted as a finding, FF p. 2, R. 358), particularly if the seller were utterly uninformed as to the financial condition and operations of the company, and in the first instance had been misinformed by a trusted source as to the value of the stock.

The District Court's Findings

The district judge's definition of "scienter" was to "deliberately and cold-bloodedly set out to conceal information which 10b-5 requires to be provided" (FF 28, R. 366, DC Opinion, R. 314), a categorical, though somewhat ingenuous, embracement of the most strict common-law definition, i.e. intent to deceive. So defining "scienter," the

district judge said the evidence did not indicate defendants' 10b-5 omissions "occurred knowingly in the 'scienter' sense" (DC Opinion, R. 314), meaning the omissions were not "knowing" in the sense of being "deliberate and cold-blooded." The district judge tied knowledge to the strictest culpability, rather than recognizing knowledge as being in itself the keystone of a less culpable, alternate definition of "scienter." Rejecting "scienter," the district judge did not discuss or analyze its multiple facets, and made no finding of ultimate fact respecting any degree of culpability less stringent than intent to deceive, or as he put it, "deliberate and wilful (cold-blooded) fraud" (R. 352).

The district judge's recital of reliance "to a considerable extent upon observation and demeanor and manner of

the witnesses when they testified" (FF 28, R. 366[4]; also R. 309, 314) is ill-considered. There was no demeanor testimony. There exists not conflicting or ambiguous testimony; a credibility choice is not present. Neither Serwold nor Coie testified as to his intent, a circumstance oddly compelled by the District Court very early in the trial during the examination of Serwold, the first witness:

> Q. Had the company entered into a contract by which it undertook to make capital improvements?
>
> THE COURT: Mr. Cameron, . . . as far as I am concerned, if these documents (exhibits) create liability, they create liability. If they don't, they don't. I am not the least bit interested in what this gentleman thinks he meant or Mr. Coie meant when they said (i.e. wrote) certain things back in

[4]Defense counsel's contention that Judge Burns "himself" (Pet. p. 12) prepared finding 28 is false. It is, verbatim, defendants' proposed finding No. 30 (Ex. 7, p. 8).

> 1965. . . . and I have extended myself in this case just as far as I am going to. I am interested in trying this lawsuit on the merits. And I am not the least bit interested in what this gentleman thinks Mr. Coie may have thought in 1965. What he said in 1965 or didn't say is what is important. Now, I hope you can proceed ahead with your questioning of this witness in light of that statement.
>
> MR. CAMERON: Yes, Your Honor. I stand chastized. . . .
>
> THE COURT: Mr. Korth's deposition was taken and you spent a great deal of time asking Mr. Korth what he understood and what he thought and what he meant. It doesn't make a bit of different to me. What is important is what was said and what was not said. . . . That is what I am interested in, because that is what depends on how this lawsuit is decided. Please proceed. . . .

(Tr. 0024-25.)

Thusly, and in a harshly-toned stricture, the district judge foreclosed inquiry into Serwold's and Coie's state of mind, viz: what either thought or meant by their actions. Having done so

and having declared his intention to decide the case on the documentary evidence, the district judge's self-supportive statement of his reliance "to a considerable extent upon observation and demeanor and manner of the witnesses when they testified," calls for no more weight than its pretentiousness suggests.

The Ninth Circuit's Conclusions

In addition to intent, the Ninth Circuit accepted a knowledge standard and also, alternatively, "recklessness, or some degree of intent not sufficiently aggravated to be characterized as 'deliberate and cold-blooded'." (576 F.2d at 1337-38.) It concluded the defendants' omissions "were, at the very least, with knowledge" (p. 1337) and that the evidence also supported application of the alternate standards (p. 1338). The district judge did not make

a finding of ultimate fact concerning any of these less strict meanings of scienter--meanings which he did not accept.

The absence of a finding of ultimate fact does not require reversal of the judgment if the circumstantial facts as found are such that the ultimate fact follows from them as a necessary inference. Confederated Bands of Ute Indians v. United States, 330 U.S. 169, 177 n. 3, 91 L. Ed. 823, 828 (1947). Conversely, ultimate facts, like conclusions of law, are subject to review free of the restraining impact of the so-called "clearly erroneous rule." Galena Oaks Corporation v. Scofield, 218 F.2d 217, 219 (5th Cir. 1954). The district judge's conclusion of law that there was a "lack of scienter" (R. 366) is not subject to the rule. 5A Moore's Federal Practice, 2d ed., § 52.03(2), p. 2662.

Findings of fact that are induced by or combine an erroneous view of the law are not binding. (Id. § 5203(3), p. 2664).

The district judge was not specific as to all the circumstantial omissions found. His findings state:

> Within the meaning of Rule 10b-5 and its state counterpart, I find that omission liability exists considering the various omissions in their entirety but particularly concentrated on . . . two central areas . . . .

(FF 27, R. 365, emphasis supplied.)

The 45 admitted facts (R. 269-81), including exhibits "A" through "N" and "FF-1," "GG-1" and "GGG-2" which "reflect the entirety of the transaction" (AF 2.12, R.270, FF 13, R. 360), and which were admitted in evidence, compel the ultimate fact of 10b-5 fraud, at least under any standard of culpability less than what the district judge characterized as "deliberate and cold-blooded." The "found" facts, of which

the district judge took particular notice (i.e., failure of corporate, insider purchasers of small, independent telephone company stock to disclose to an uninformed seller the existence, and the relationship to the insiders, of a control group and its intent to acquire a majority of the shares, build up the company and to sell it), compel the same ultimate fact conclusion, and all the more so when active solicitations for sale or merger of the company were to commence the very next year (R. 346-47, 350, Tr. 0104-5). See Monsen v. Consol. Dressed Beef Co., Inc., 579 F.2d 793, 803 n. 17, 804 (3rd Cir. 1978).

Additional "found" facts contained in the district judge's Opinion (R. 309) and adopted as findings (FF p. 2, R. 358) also compel an ultimate fact conclusion of 10b-5 fraud, viz., the undisclosed specified increases in earnings

per share and in book value per share during the 1962-65 hiatus in correspondence, as compared to the initial offer of $5.00 per share, of which the District Judge said:

> In short, I conclude that the evidence preponderates on this issue in Plaintiff's favor, and hence, that omission liability under 10b-5 exists (R. 311, cf. R. 312, line 32, -- R. 313, lines 1-13, and see the district judge's curious footnote to his Opinion concluding, even aside from the Insider Rule, which he seemed incapable of fitting within his analysis, 10b-5 "omission liability" established "as a matter of fact and law."

(R. 315).

Oddly, in addition to "usurpation" (Petition p. 26), defendants charge the Ninth Circuit with having violated F.R.C.P. Rule 52(a), though its Opinion is consistent with the District Court's findings, and the rule is but a limitation upon making findings inconsistent with the latter. There is gross deceit in these charges. When defendants say the district judge "explicitly found"

that the nondisclosure did not occur "knowingly in the 'scienter' sense" (Pet. p. 23), they do not state the context in which the statement was made; that the district judge was not alluding to a less strict knowledge culpability, but meant that the omissions were not knowing in the sense of being "deliberate and cold-blooded". The defendants also emphasize the ill-considered recital in the findings that the district court relied upon his "observation of the demeanor and manner of the witnesses when they testified." There exists neither conflicting nor ambiguous testimony; a credibility choice is not present; and the logic of the recital is inappropriate to the district judge's stricture at the commencement of the trial against plaintiff inquiring as to defendants' or Coie's state of mind at the time of the fraud (supra, p. 45).

Appellate courts are free to draw inferences and conclusions from admitted facts and findings and are in as good a position to weigh deposition and documentary evidence as is the trial judge. Gillette's Estate v. C.I.R., 182 F.2d 1010, 1014-15 (9th Cir. 1950), reversing a state-of-mind determination, stating the Circuit Court is "as well equipped to draw inferences as is the Tax Court, and for that reason the Tax Court decision calls for little more weight than its logic suggests." See also Western Union Telegraph Co. v. Bromberg, 143 F.2d 288, 290 (9th Cir. 1944). Although the Ninth Circuit did not overturn any finding of fact, it is said that the burden of showing a finding of fact "clearly erroneous" is "much lighter" when the facts are undisputed or the evidence is documentary. Galena Oaks Corporation v. Scofield, 218 F.2d 217, 219 (5th Cir. 1954).

The Damages Issue

The district judge refused to believe that this Court actually meant what it said when, in an opinion by Mr. Justice Blackmun, it clearly, and unequivocally, stated the measure of 10b-5 damages for defrauded sellers, viz: ". . . where the defendant received more than the seller's actual loss, (the) damages are the amount of the defendant's profit." Affiliated Ute Citizen v. United States, 406 U.S. 128, 155, 31 L. Ed. 2d 741, 762 (1972). As stated in the seminal 10b-5 disgorgement-of-profits case, Janigan v. Taylor, 344 F.2d 781, 786 (1st Cir. 1965): "It is simple equity that a wrongdoer should disgorge his fraudulent enrichment."[5]

[5]Accord: SEC v. Shapiro, 494 F.2d 1301, 1309 (2d Cir. 1974), Zeller v. Bogue Electric Mfg. Corp., 476 F.2d 795, 801-802 (2d Cir. 1973), Rochez Bros., Inc. v. Rhodes, 491 F.2d 402, 411-412 (3rd Cir. 1974), Baumel v. Rosen,

That the defrauded seller's damages may exceed his actual loss rests not alone on the disgorgement principle, but also, quite independently, upon the doctrine of "rescissional damages" originating, at least in 10b-5 law, with Myzel v. Fields, 386 F.2d 718 (8th Cir. 1967), cert. denied, 390 U.S. 951, 19 L. Ed. 2d 1143, (1968). There, a problem arose as to how rescission could be determined by a jury when that remedy is

[5](cont.)412 F.2d 571, 575-576 (4th Cir. 1969), Ohio Drill & Tool Co. v. Johnson, 498 F.2d 186, 190-191 (6th Cir. 1974), Chasins v. Smith, Barney & Co., 306 F. Supp. 177, 178 (S.D.N.Y. 1969). The disgorgement principle is not peculiar to 10b-5 violations resulting in unjust enrichment. See, for example, Clark v. Bunker, 453 F.2d 1006, 1011 (9th Cir. 1972), applying the principle to misappropriation and use of a trade secret. In Schur v. Salzman, 365 F. Supp. 725, 735 (D.C.N.Y. 1973), dealing with another section of the Act, the court said: "The courts have been consistent in the view that the most effective way to enforce section 16(b) [15 USC § 78p(b) creating insider liability for short swing profits] is a rigid rule taking all the profits out of any transaction which comes within its proscription."

available solely in an equitable action.

Judge Lay held:

> But in an action at law a jury may award rescissional damages if the contract has already been mutually rescinded or is otherwise set aside by law. (Citations omitted). Here, neither the jury nor the court was required to rescind the agreement; Section 29(b) of the statute itself declares the sale void, once there is found a violation of Rule 10b-5. 15 U.S.C. § 78cc(b); . . . If the contract was void as a matter of law, the plaintiff was entitled to restitution of what he sold, or, since restoration of the stock was here impossible, an equivalent money judgment.

(pp. 741-742.)[6]

---

[6]Restitution does not depend upon the existence of the element of intent to deceive but is available against even the innocent wrongdoer. Gerstle v. Gamble-Skogmo, Inc., 298 F. Supp. 66, 101 (D.C.N.Y. 1969), aff'd., 478 F.2d 1281 (2d Cir. 1973). A Federal Court may use any available remedy to make good the wrong done and, according to the exigencies of the particular case, may fashion a remedy to rescind a fra udulent sale, to secure restitution and even to enforce the right to restitution against a third party holding a defrauded seller's assets. J. I. Case Co. v. Borak, 377 U.S. 426, 433, 12 L. Ed. 2d 423, 428 (1964).

Here, the District Court strayed into and accepted the clearly erroneous argument made by defendants in Myzel, the contention being that damages for less than "deliberate and cold-blooded" nondisclosure do not extend to accretional value but only to "out-of-pocket" losses. Judge Lay put the matter to re st, holding:

> But there exists no apparent reason to apply different rules of damage to different violations under the Act. The act of nondisclosure is the evil proscribed, not the motive that induced it.

Myzel, supra, pp. 747-748.

Three years later this Court ruled similarly as Judge Lay, holding in Mills v. Electric Auto-Lite Co., 396 U.S. 375, 386-387, 24 L. Ed. 2d 593, 603-604 (1970), involving violation of § 14(a) of the Act (misleading proxy statement) that § 29(b) of the Act [15 USC § 78cc(b)] renders the sale void "at the

option of the innocent party . . . giving him the right to rescind", stating preparatory thereto that the specific unlawful activity committed "implies nothing about the form of relief to which they (plaintiffs) may be entitled", and "that upon finding a violation the courts (are) to be alert to provide such remedies as are necessary to make effective the congressional purpose".

Aside from either the disgorgement principle or the rescissional damages doctrine, the special facts of this case, partially noted in the Opinion, 576 F.2d at 1339, n. 5, compel a conclusion that but for the fraud, plaintiff would have realized in January, 1972, 25 shares of United (a value of $500) for each PRTA share. Under these circumstances, plaintiff is entitled to be put in substantially the position in which

he would have been but for the fraudulent deprivation of his stock. Restatement of Restitution, § 151, comment c (1937).

The district judge viewed rescissory damages as the "equivalent" of restitution, deemed either an "exceptional remedy" and rejected each as "an inappropriate remedy" because "the fraud involved" was not "relatively severe" but involved only omissions (R. 351, incorporated as Conclusions, R. 358-59). He took no heed of the special facts partially noted in the Opinion, 576 F.2d at 1339 n. 5, showing, but for the fraud, plaintiff would have realized defendants' gain. Rejecting the appropriate measure of damages, he fashioned a minimal out-of-pocket recovery which failed to give any recognition to the actual or intrinsic value of the stock, as measured either by the going-concern value of

the Company or by the true value of its net assets, nor as measured by the non-disclosed intent of the control group to sell the Company, the very nondisclosure upon which the court found liability.[7]

To support the stingy award, the district judge cited "defendants' (post-sale) efforts contributing to the growth and increase in value of PRTA" (R. 352). However, there exists not one quark of evidence of such efforts. Even the contention thereof originates with the district judge and was not advanced at trial. The admitted fact is that prior to the securities transaction, the Com-

[7]The district judge said he was "impressed" by, and largely "accepted (the) opinion" (R. 354) of, defendants' surprise, "expert" witness who testified post-trial to his examination of a far-off, unrelated telephone company, and whose testimony was taken without fair notice to plaintiff in violation of the district judge's own counsel letter (R. 351, 353) and of plaintiff's rights under F.R.C.P. 26(b)(4)A. Plaintiff's timely objections (Tr. 0148-49) were overruled (Id.). The Ninth Circuit apparently treated as moot plaintiff's assignment of error on the matter.

pany's "build up" had largely occurred and it was experiencing "steady growth" (AF 2.33, R. 279).

The district judge concluded that plaintiff's damages should be calculated on the basis of the fair market value of the stock as of December 31, 1967, for the reason that this value represents the highest value reached by the stock within a reasonable time after the sale thereof. (Conclusion of Law 1, R. 366-367). Anomalously, that conclusion would fix the damages even before the statute of limitations commenced, which was when plaintiff discovered the fraud or could have done so in the exercise of reasonable diligence. Hilton v. Mumaw, 522 F.2d 588, 601-602 (9th Cir. 1975). The district judge's conclusion assumes the fraud terminated at or about the time of the sale, when in fact defendants owed to plaintiff a continuing

duty of disclosure to the time of the latter's actual or constructive discovery of the fraud. Defendants' fraud continued to the date of sale to United (Tr. 0091-92).

The gist of the district judge's ruling is that if a wrongdoer can escape detection "for a reasonable time" after his fraud (in his opinion, not more than 27.5 months), he is home free and may keep all profits or enrichment which thereafter accrue. Such a result rewards concealment, fails to effectuate the congressional purpose of the Act (i.e., protect investors, including deterrence of insider fraud), is unfair to the victim, and is, of course, contrary to law. The correct time frame for ascertaining the value of the stock for the purpose of measuring damages is the time of discovery of the fraud. In Gerstle v. Gamble-Skogmo, Inc., 478 F.2d

1281, 1306 n. 27 (2d Cir. 1973), Chief Judge Friendly stated:

> Section 151, comment c, of the Restatement of Restitution, cited both in Janigan and in Myzel . . . limits recovery to "the highest value reached by the subject matter within a reasonable time after the tortious conduct". If the fraud is such that it could not reasonably be discovered until a later date, the rule is that recovery is limited to the highest value reached within a reasonable time after that date. See, e.g., Baumel v. Rosen, supra, 412 F.2d at 576. . . .

That measure which is the highest value reached within a reasonable time after the fraud is not a limitation on damages, but actually is an alternative which may be invoked by the plaintiff. Baumel v. Rosen, 412 F.2d 571, 574 (4th Cir. 1969). Myzel v. Fields, 386 F.2d 718, 746 (8th Cir. 1967) states:

> Actually, damage for tortious conversion by deceit provides a comparable legal remedy. (Citations omitted). The federal courts have historically approved a rule of damages for conversion of stock measured by the price at the time of conversion or the highest inter-

> mediate value reached within a reasonable time after notice of the conversion by the plaintiff, whichever is greater.

(Emphasis supplied; see also p. 746 n. 25).

The Tenth Circuit fixes 10b-5 damages, even in defrauded buyer cases, as of the date of discovery (or notice) of the fraud. Richardson v. MacArthur, 451 F.2d 35, 43-44 (10th Cir. 1971). The discovery rule is particularly appropriate when, as here, the actual value of the stock cannot be determined until discovery of the fraud. See, Esplin v. Hirschi, 402 F.2d 94, 104-105 (10th Cir. 1968), Loss, Securities Regulation 1630 and 1793 (2d Ed. 1961); Restatement of Torts, § 549, comment c (1938).

Much as an afterthought, the district judge opined that "Plaintiff could have discovered the inaccuracies of this transaction. . . by asking for additional financial information" (R. 352). If

none of the other 150 PRTA shareholders, or even the Washington Utilities & Transportation Commission (which took annual affidavits on the subject), ever discovered the existence of the control group, which is the admitted fact (AF 2.23, R. 274-75), it is odd the district judge should believe defendants would ever have revealed their secret to plaintiff. Indeed, it is naive to think that defendants would have given plaintiff, upon request, any "additional financial information" (as if any, except for the $5.00 offer, had been given). PRTA admittedly did not give out financial statements or other reports and held no meetings of shareholders. (AF 2.24-2.26, R. 275-76). Also, of course, it was defendants' duty to disclose, not plaintiff's duty to inquire.

Quoting Blackie v. Barrack, 524 F.2d 891, 908 (9th Cir. 1975), defense

counsel contends the District Court, not plaintiff, is entitled to choose the remedy. His quotation from the case is wrenched from context of a class action involving potential conflicting interests of class members in proving damages and the sufficiency of such conflicts to defeat class action status. Surely, in such a case, it is for the district judge to promptly decide, preliminarily ("in the first instance" p. 909), which of the requested remedies is appropriate. In Blackie, the alleged conflicts depended entirely on adoption of the out-of-pocket loss measure of damages and were avoided on adoption of the rescissory measure. 524 F.2d at 908. Also, Blackie is a defrauded purchaser case requiring a damages choice between either a price-value differential or between the price paid and a later price received. See, Chasins v. Smith, Barney

& Co., 438 F.2d 1167, 1173 (2d Cir. 1970). Here, there is only one correct measure of damages--the rescissory/disgorgement measure. Affiliated Ute Citizens v. United States, 406 U.S. 128, 155, 31 L. Ed. 2d 741, 762 (1972).

From the beginning plaintiff has sought, exclusively, either restitution in the form of an equivalency award of United Telephone stock and dividends or rescissory damages. (Complaint, R. 1, 6-7.) Just as a defrauded buyer may "choose" rescission, instead of the difference between the value of what he gave up and the value of what he received, a defrauded seller is entitled "to choose" the rescissory measure of damages. Abrahamson v. Fleschner, 392 F. Supp. 740, at 746 (S.D.N.Y. 1975). The nature of the relief sought, not the statute which creates the right, determines the legal or equitable remedy.

Myzel v. Fields, 386 F.2d 718, 741 (8th Cir. 1967), Straley v. Universal Uranium & Milling Corp., 289 F.2d 370, 373 (9th Cir. 1961).

Defense counsel suggests requiring return of ill-gotten gains is "too draconian," citing Gerstle v. Gamble-Skogmo, Inc., 478 F.2d 1281, 1304-1306 (2d Cir. 1973). There, the Second Circuit refused to require the defendants to account for unrealized appreciation, when the fraud related only to realized gain, but approved an award to plaintiff of the profits realized by defendants. However, the court said:

> We would agree that the Janigan principle is not confined to situations where the purchaser resells within a short time, and that in a proper case a court could award a plaintiff the unrealized appreciation of securities obtained through fraud. . . .

(p. 1305.)

Federal Issues Superseded

Issue: Will the Securities Act Amendment, RCW 21.20.430(2) (1975), amended 1977, be applied retroactively to lawsuits alleging violation of RCW 21.20.010 (1959) filed prior to the effective dates of the amendment, viz: September 8, 1975, and September 21, 1977? Plaintiff contends "yes!"

The Washington counterpart of Rule 10b-5, RCW 21.20.010 ("Section 10") has remained unchanged since its enactment in 1959. Aping 10b-5 history, a private cause of action for damages was implied from Section 10 in an insider, purchaser's fraud case, Shermer v. Baker, 2 Wn.App. 845, 472 P.2d 589 (1970). At that time the civil liabilities section of the Securities Act (RCW 21.20) expressly created a damages cause of action only in favor of a defrauded purchaser against: "Any person, who . . .

sells a security by means of fraud or misrepresentation . . ." RCW 21.20.430(1) (1959), emphasis supplied. In 1975 the legislature added to the Securities Act subsection .430(2) creating a damages cause of action against: "Any person who buys a security by means of fraud or misrepresentation. . ." RCW 21.20.430(2) (1975), emphasis supplied.

There followed Ludwig v. Mutual Real Estate Investors, 18 Wn.App. 33, 567 P.2d 658 (1977), a seller's fraud case. Focusing on the statutory words "by means of fraud or misrepresentation," and failing to discuss negligent misrepresentation long recognized in Washington, the state court of appeals adopted the federal scienter requirement, and, noting the aforesaid "erstwhile statutory omission has since been remedied," 18 Wn.App. at p.42, opined

that a private cause of action for damages should not be implied from RCW 21.20.010, in all respects overruling, sub silentio, the Shermer case.

The legislative reaction was swift. The legislature neatly cut out of the Securities Act "by means of fraud or misrepresentation," substituting therefor "in violation of the provisions of RCW 21.20.010." RCW 21.20.430(1) and (2) (1977). The latter amendment now reads:

> (2) Any person who buys a security in violation of the provisions of RCW 21.20.010 is liable to the person selling the security to him, who may sue either at law or in equity to recover the security, together with any income received on the security, upon tender of the consideration received, costs, and reasonable attorneys' fees, or if the security cannot be recovered, for damages. Damages are the value of the security when the buyer disposed of it, and any income received on the security, less the consideration received for the security, plus interest at eight percent per annum from the date of disposition, costs, and reasonable attorneys' fees.

The tender, a 1977 innovation, may be made at any time before entry of judgment. RCW 21.20.430(6) (1977).

The substantive anti-fraud provisions of the Securities Act, RCW 21.20 .010--the Washington counterpart of Rule 10b-5--became effective June 10, 1959, years before the fraud involved in this case. In addition to administrative (RCW 21.20.110 and 280), injunctive (RCW 21.20.390), and criminal (RCW 21.20.400) remedies, a statutory damages action in favor of defrauded purchasers, and, at the time of the judgment herein and until 1977, an implied damages action in favor of defrauded purchasers and sellers, has always lain for violation of RCW 21.20.010. RCW 21.20.430(2) became effective subsequent to the fraud herein involved and the commencement of this suit. Neither that provision nor any

other amendment contains any language expressing the legislative intent with respect to the question of retrospective or prospective operation of RCW 21.20.430(2). The question has not been before the Washington appellate courts.

Though a statute ordinarily operates prospectively, it will be applied retrospectively if it is remedial. Tellier v. Edwards, 56 Wn.2d 652, 354 P.2d 925 (1960). A statute is remedial and has retroactive application when it relates to practice, procedure or remedies and does not affect a substantive or vested right. Ibid, p. 653; Nelson v. Dept. of Labor & Industries, 9 Wn.2d 621, 115 P.2d 1014 (1941).

Though the question is one of legislative intent, it is not necessary that the statute expressly state that it shall operate retrospectively. Pape v. Dept. of Labor & Industries, 43 Wn.2d

736, 741, 264 P.2d 241 (1953). In Pape at p. 741, the Washington Supreme Court said:

> In the absence of language showing a contrary intent, a new law changing a remedy is generally regarded as applicable to all remedies--those which have accrued and those which will accrue in the future.

The presumption favoring prospective application is actually reversed if the statute is remedial and its remedial purpose is furthered by retroactive application. Haddenham v. State of Washington, 87 Wn.2d 145, 550 P.2d 9 (1976). In that case the reverse presumption of retrospectivity was applied to the state crime victims compensation act, (RCW 7.68), which abolished all actions against the state for injury or death as a consequence of a criminal act and incorporated for crime victims the workmen's compensation benefit schedule. In 1977, the legislature repealed RCW 7.68.040, the abolition-of-civil-actions

provision. Holding the amendment remedial in purpose, the Washington Supreme Court held the amendment applied retroactively. Holt v. Moses Lake, 89 Wn.2d 376, 572 P.2d 1100 (1977).

In Lau v. Nelson, 89 Wn.2d 772, 575 P.2d 719 (1978), the Washington Supreme Court held that repealing acts terminate all rights dependent upon the repealed statute and thus operate retroactively. Hence, a 1974 law repealing the Washington host-guest statute (RCW 46.08.080) was applied retroactively.

In Godfrey v. State of Washington, 84 Wn.2d 959, 530 P.2d 630 (1975), the Washington Supreme Court unanimously ruled that the state's 1974 comparative negligence statute applies to every cause of action for which judgment is entered subsequent to the effective date of the statute, regardless of when the action arose. The reasoning of the

court was that the defense of contributory negligence is not a substantive right but a procedural matter. As a measure of the relative ease in which retrospectivity is presumed in Washington, as compared to other states, at least five other states have been faced with the same question of retrospectivity raised in Godfrey, yet the courts of all five decided the comparative negligence statute should be applied only prospectively.[8]

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[8] Reddell v. Norton, 225 Ark. 643, 285 S.W.2d 328 (1955); Moore v. Fenton, 289 A.2d 698 (Me. 1972); Fuller v. Illinois Cent. R.R., 100 Miss. 705, 56 So. 783 (1911); Joseph v. Lowery, 261 Ore. 545, 495 P.2d 273 (1972); Holzem v. Mueller, 54 Wis.2d 388, 195 N.W.2d 635 (1972) (as to an amendment to the statute); Brewster v. Ludtke, 211 Wis. 344, 247 N.W. 449 (1933).

The cogent and persuasive reason supporting the Godfrey decision was the practical problems a dual system of recovery would create for litigants and the courts. The Godfrey court said:

> It would be incongruous indeed to frustrate this obvious legislative change in policy by adopting a position that would permit the rejected bar to recovery (contributory negligence) to continue in operation for years to come. Yet, such would be the result if we were to hold the operation of RCW 4.22.010 and .020 (comparative negligence statutes) to be prospective only.

84 Wn.2d at 967, 530 P.2d at 634.

RCW 21.20.430(2) is remedial in purpose and therefore applies retroactively. Created by a 1975 amendatory act, its purpose is to provide a statutory civil damage remedy against purchasers of a security who violate Section 10 of the Securities Act, precisely as was previously implied in the Shermer decision. The amendment corrected a legislative oversight in creating a remedy for a purchaser but not a seller.

The 1977 amendment further focuses on remedy, eliminating strict proof of fraud, creating a return to Shermer v. Baker, 2 Wn.App. 845, 472 P.2d 589 (1970), and redefining damages. It is unlikely that a Washington court would construe RCW 21.20.430(2) not to operate retrospectively and thereby accept a dual system of recovery rejected in the Godfrey decision. Obviously, the remedial statute renders moot the federal issues in this case.

CONCLUSION

The Ninth Circuit has sustained the District Court's findings relating to defendants' liability and, consistent therewith, has properly drawn inferences and conclusions from those findings, inferring the ultimate fact "that the defendants' omissions were, at the very least, with knowledge." 576 F.2d at

1337. The parties' stipulation of virtually all the evidence, reduced to forty-five agreed facts plus designated documents reflecting the entirety of the transaction, expands the scope of judicial review and placed the Ninth Circuit in as good a position as the District Court to weight such evidence and draw inferences therefrom, and especially so, since this case was not decided upon the basis of a credibility choice and the District Court was not burdened with resolution of conflicting or ambiguous testimony. Appellate courts are free to overturn erroneous conclusions of law, and the Ninth Circuit has done so both in respect to clarification of the District Court's conclusion referring to "the lack of scienter" (by which it meant "lack of intent to deceive") and its erroneous rejection of the correct measure of damages. In addition, the

Federal issues have been rendered moot (superseded) by the retroactive amendment of the Washington Securities Act and the attendant ascendancy of the adjudicated violation of RCW 21.20.010.

Defendants' Petition For Writ of Certiorari should be denied.

Respectfully submitted,

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Oct. 13, 1978

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IN THE

Supreme Court of the United States

October Term, 1978
No. 78-182

O. E. SERWOLD and HELEN SERWOLD, his wife,

Petitioners,

vs.

KENNETH N. NELSON,

Respondent.

On Petition for Writs of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Motion for Leave to File Brief Amicus Curiae of Stephen W. Holohan in Support of the Respondent Kenneth N. Nelson and Brief Amicus Curiae of Stephen W. Holohan.

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IN THE

Supreme Court of the United States

October Term, 1978
No. 78-182

O. E. SERWOLD and HELEN SERWOLD, his wife,

Petitioners,

vs.

KENNETH N. NELSON,

Respondent.

On Petition for Writs of Certiorari to the United States Court of Appeals for the Ninth Circuit.

Motion of Stephen W. Holohan for Leave to File Brief Amicus Curiae.

To the Honorable Chief Justice and Associate Justices of the Supreme Court of the United States:

Stephen W. Holohan respectfully moves this Court, pursuant to Supreme Court Rule 42(1), for leave to file the accompanying brief in this matter as amicus curiae in support of the Respondent, Kenneth Nelson. In support of this motion, Stephen W. Holohan shows as follows:

1. The parties in this action have not been contacted relative to consent because the time allowed for the filing of the brief of the party supported has expired.

2. While the brief is submitted late, it is requested that the motion for leave to file brief amicus curiae be granted for the following reasons:

a. The cases and literature screened by amicus curiae indicate general acceptance of the decision in *Affiliated Ute Citizens v. United States*. The amicus curiae brief questions the soundness of that decision.

b. The deceit frame of reference endorsed by *Affiliated Ute* clouds those prohibitions of Rule 10b-5 dealing with other than deceit. Consequently, notions of recklessness that are unrelated to deceit or to the "omissions"-"deceit" concepts of *Affiliated Ute* have been obscured. This brief outlines those notions.

3. Stephen W. Holohan is a Los Angeles attorney, who is a plaintiff's attorney in a Rule 10b-5 litigation in the Central District of California, which involves recklessness issues.

STEPHEN W. HOLOHAN,
Attorney for Amicus Curiae.

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BRIEF AMICUS CURIAE OF STEPHEN W. HOLOHAN.

INTEREST OF THE AMICUS.

The interest of the amicus is to ascertain the definition of recklessness relative to Rule 10b-5 matters.

INTRODUCTION AND SUMMARY OF ARGUMENT.

Recklessness has been utilized as a standard of culpability in Rule 10b-5 decisions. The definitions which have been used, fall into two categories: (1) reckless disregard for the truth, and (2) reckless conduct in omissions cases.

The purpose of this brief is to demonstrate:

1. That Rule 10b-5 prohibits conduct classifiable as either fraud or deceit, but not just omissions. Classifying conduct as an omission dissolves the express distinction between fraud and deceit set up in the prohibitive clauses of the rule.
2. That if item (1) is correct, then the categories of recklessness become (1) reckless disregard for the truth, and (2) recklessness as to consequences. This dichotomy harmonizes with the prohibitive clauses of Rule 10b-5, but, coincidentally, requires that each prohibitive clause be treated as an independent basis of liability. If clauses (1) and (3) of the rule are each an independent basis of liability other than deceit, then the elements of each are, therefore, other than the elements of common law deceit.

I
ASSUMPTIONS.

For the purpose of this brief, certain assumptions are made:

1. *Liability for knowing conduct.* In *Ernst & Ernst v. Hochfelder,* 425 U.S. at 197, the Court states:

> Section 10(b) makes unlawful the use or employment of "any manipulative or deceptive device or contrivance" in contravention of Commission rules. The words "manipulative or deceptive" used in conjunction with "device or contrivance" strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct.

This brief assumes that the Supreme Court has determined that liability in Rule 10b-5 matters is to be subjective.

2. *Recklessness: subjective or objective.* In *Ernst & Ernst,* 425 U.S. at 193-194 n. 12, the Court states:

> In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.

This brief assumes, that while the question of whether recklessness is a proper standard of culpability in Rule 10b-5 matters is open, the question of whether recklessness is a subjective or objective standard is not. In light of the proscription against knowing or intentional misconduct, it is assumed that the Court refers to a subjective concept of culpability.

II
OMISSIONS CASES.

Affiliated Ute reads at 406 U.S. 153-154 as follows:

> To be sure, the second paragraph of this rule specifies the making of an untrue statement of a material fact and the omission to state a material fact.

Rule 10b-5(2) reads in part:

> . . . (t)o omit to state a material fact necessary in order to make the statement made in light of the circumstances under which they were made not misleading.

At common law, this notion was called a half-truth in that if the defendant does speak, he must disclose enough to prevent his words from being misleading. A half-truth is a form of deceit.

In the chapter on Fallacies of Observation in John Stuart Mills, *A System of Logic* (Volume VIII of The Collected Works, University of Toronto Press 1974) at 773 it reads:

> A fallacy of misobservation may be either negative or positive; either Non-observation or Mal-observation. It is non-observation, when all the error consists in overlooking, or neglecting, facts or particulars which ought to have been observed. It is mal-observation, when something is not simply unseen, but seen wrong; when the fact or phenomenon, instead of being recognized for what it is in reality, is mistaken for something else.

The view of this brief is that Rule 10b-5(2) has been misread by the *Affiliated Ute* decision insofar as that decision treats "the omission to state a material

fact" as an independent ground for relief. A corollary view is that the latter part of Rule 10b-5(2) is nothing more or less than the half-truth notion applied to the securities field. The *Affiliated Ute* decision obliquely illustrates this position. *Affiliated Ute Citizens* reads at 406 U.S. 154 as follows:

> The obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact. *Chasins v. Smith, Barney & Co.*, 438 F.2d at 1172.

Chasins at 1172 reads:

> Chasins relied upon Smith, Barney's recommendations of a purchase made without the disclosure of a material fact, purchased the securities recommended, and suffered a loss in their resale. Causation in fact on adequate reliance was sufficiently shown.

Clearly, this passage from *Chasins* evidences a half-truth situation, *i.e.*, recommendations which mislead because of the omission of the material fact. In short, it is a classic deceit case. Moreover, *Chasins* explicitly bases causation in fact on reliance, and not an obligation to disclose and the withholding of a material fact as stated in *Affiliated Ute*.

The consequence of the mal-observation of Rule 10b-5(2) was the oft-cited *Affiliated Ute* passage.

> Under the circumstances, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision.

> See *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 384 (1970); *SEC v. Texas Gulf Sulphur Co.*, 401 F.2d 833, 849 (CA 2 1968), cert. denied sub nom.; *Coates v. SEC*, 394 U.S. 976 (1969); 6 L. Loss, *Securities Regulation* 3876-3880 (1969 Supp. to 2d ed. of Vol. 3); A. Bromberg, *Securities Law Fraud—SEC Rule 10b-5* §§ 2.6 and 8.6 (1967).

Hence, while the "omission to state a material fact" was severed from its common law deceit antecedents, the decision immediately applied the elements of common law deceit to the freshly minted cause of action for omitting to state a material fact. Consequently, although a deceit was not presented on the facts, the decision held that deceit elements applied. But the decision was not able to apply the deceit elements directly, because inasmuch as there was no statement, there could be no reliance. To skirt this quandary, two fictions were established: (1) reliance was not a prerequisite to recovery, and (2) an obligation to disclose and the withholding of a material fact establish causation in fact.

Professor Fuller states in Legal Fictions, (1967) at 9:

> A fiction is either (1) a statement propounded with a complete or partial consciousness of its falsity, or (2) a false statement recognized as having utility.

The *Affiliated Ute* decision does not indicate which of these two notions may have been the basis for the fictions which the decision established.

Classification of Rule 10b-5 Offenses.

The consequence of the *Affiliated Ute* decision has been the tendency to funnel all claims for relief under Rule 10b-5 into deceit actions, *i.e.*, Rule 10b-5(2) claims.

A fuller excerpt from *Affiliated Ute* reads at 406 U.S. 152-153:

> To be sure, the second subparagraph of this rule specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs are not so restricted. These defendants' activities, outlined above, disclose, within the very language of one or the other of those subparagraphs, a "course of business" or a "device, scheme, or artifice" that operated as a fraud upon the Indian sellers. *Superintendent of Insurance v. Bankers Life & Casualty Co., supra.* This is so because the defendants devised a plan and induced the mixed-blood holders of UDC stock to dispose of their shares without disclosing to them material facts that reasonably could have been expected to influence their decisions to sell. The individual defendants, in a distinct sense, were market makers, not only for their personal purchase constituting 8-1/3% of the sales, but from the other sales their activities produced. This being so, they possessed the affirmative duty under the Rule to disclose this fact to the mixed blood sellers. See *Chasins v. Smith, Barney & Co.*, 438 F.2d 1167 (C.A. 2d 1970).

Just as in *Affiliated Ute*, other courts have used the notion of "failure to disclose" to bring the facts of a particular case into a deceit context.

In this case, *Nelson v. Serwold*, 576 F.2d 1332 (9th Cir., 1978), this method is repeated:

> We agree with the district court's findings that the omissions, considered in their entirety, but with particular reference to nondisclosure of the control group and its long-range plan are material within the meaning of Rule 10b-5. (p. 1336.)

Elsewhere, the court stated:

> The existence of a plan to acquire control of Poulsbo Telephone, strengthen and sell it is supported by the facts that the control group set out to acquire a majority of the stock; they ceased affirmative efforts to acquire stock after achieving control; they set out on a plan of modernization; they entertained "feelers" from and negotiated with potential purchasers of the company; and they eventually sold it for a substantial gain. (p. 1336.)

Hence, just as in *Affiliated Ute*, the conduct above could be characterized as being within the first and third subparagraphs of Rule 10b-5, but was not.

III
RECKLESSNESS.

Preliminary Observation.

In *The Mental Element in Crime—A Legislative Problem*, by Remington and Helstad, 1952 Wisc. L. Rev. 644, at 673-675, the problems associated with defining recklessness were discussed. The authors' comments are appropriate in the Rule 10b-5 context, and are therefore excerpted in detail:

> To form a statutory definition of either negligence or recklessness for the purpose of criminal liability is not easy. The conceptual difficulty inherent

in the problem, makes clear and concise statutory formulation, insofar as that is possible, more important in this area than in any other. The present confusion resulting from the inconsistent use of terminology in the statutes alone warrants revision. But more than that can be accomplished. Preliminary to statutory formulation, there should be a policy determination of whether liability is to be objective or subjective. . . . (H)aving made that decision, the basis chosen should be stated as clearly as possible. There are several aspects of the problem:

1. If the basis of liability is to be objective, it is not sufficient to phrase the standard in terms of "negligence" modified by an epithet which serves to put people on warning that ordinary negligence is not sufficient. To stop there would still leave the question of whether liability is to be objective or subjective. . . .

2. In those crimes where a subjective mental state is required, that mental state ought to be clearly defined. It is not enough to use terms like "wilful and wanton". "Wilful" cannot mean what it seems to or the crime would be based on intent. "Wanton" leaves much room for doubt. It may be decided that liability for certain consequences will result if the actor was aware of the circumstances which existed at the time he committed his dangerous act, even though he did not appreciate that he was creating a danger to others. If so, there is no reason why that cannot be clearly stated in the statutory form. On the other hand, it may be decided that liability should not result unless the actor was aware of the fact

that he was creating a risk to the safety of others. If so, that should be stated. There are bound to be difficulties.

Definitions.

Miscellaneous definitions of recklessness have been used in securities law, tort law, and criminal law. A representative sample is outlined below in the following format.

A. Securities Law
   1. Gross negligence
   2. Reckless disregard for the thruth
      a. Subjective standard
      b. Objective standard
   3. Constructive knowledge
   4. Recklessness as to consequence
   5. Distinctions blurred

B. Tort Law
   1. Reckless disregard for the truth
      a. Objective standard
      b. Subjective standard
   2. Recklessness as to consequences
      a. Subjective standard
      b. Objective standard
   3. Substantially certain consequences

C. Criminal Law
   1. Gross negligence
   2. Recklessness as to circumstance
   3. Recklessness as to consequence
   4. Wilful blindness

A. Securities Law.

1. Gross negligence
   a. *Bailey v. Meister Brewing, Inc.*, 535 F.2d 982, 993 (7th Cir., 1976)
      1. While there was no direct knowledge, the court below found that, at the least, Continental and its participating officers and controlled directors

         were grossly negligent in failing to recognize the unfairness of the asset transfer

         and

         blinded by a conflict of interest, wantonly ignore(d) evidence of the unfairness of (the) securities transaction to the corporation and therefore fail(ed) to disclose this evidence to those shareholders whose interests lie with the corporation.

2. Reckless disregard for the truth
   a. Subjective standard
      1. *McLean v. Alexander*, 420 F.Supp. 1057, 1084 (Del., 1976)
         a. There is little reason to distinguish between knowing misbehavior under Section 10(b) and Rule 10b-5. In practice, one who recklessly makes a statement inherently possesses some knowledge of its falsity. The common law, precedent in other fields, and the legislative history of 10

(b) all buttress the viewpoint that 10b-5 liability ought to attach upon a showing of recklessness

3. Constructive knowledge
   a. *SEC v. Frank*, 388 F.2d 486, 489 (2nd Cir., 1968)
      1. If this is so, the Commission would be entitled to prevail; a lawyer, no more than others, can escape liability for fraud by closing his eyes to what he saw and could readily understand.

4. Recklessness as to consequence
   a. Subjective
      1. *SEC v. National Student Marketing Corp.*, 402 F.Supp. 641, 648 (D.C. Cir., 1975)
         1. The traditional view relied on by Katz is that one acting solely as an attorney will not be held in violation of the securities laws as an aider and abettor unless he had actual knowledge or acted in a wilful and reckless disregard of a fraudulent scheme in which he played an essential part.
   b. Objective standard
      1. *Franke v. Midwestern Oklahoma Development Authority*, CCH Fed. Sec. L. Rptr. (1976-1977 Transfer Binder) ¶ 95,786, at 90,846, 90,850 (W.D. Okla., 1976)

a. In the context of an omissions case, reckless conduct may be defined as a highly unreasonable omission, involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it.

2. *Sundstrand Corporation v. Sun Chemical Corporation,* CCH Fed. Sec. L. Rptr. (1976-1977 Transfer Binder) ¶ 95,887, at 91,252, 91,260 (7th Cir., 1977)

   a. Indeed the Franke definition of recklessness should be viewed as the functional equivalent of intent (citations omitted) . . . While this definition might not be the conceptual equivalent of intent as a matter of general philosophy, it does serve as a proper legally functional equivalent for intent, because it measures conduct against an external standard which, under the circumstances of a given case, results in the conclusion that the reckless man should bear the risk of his omission (citation omitted). When

measured against this external standard, it may be said that such a reckless man has "use(d) or employ(ed) (a) deceptive device" within Section 10(b).

3. *Continental Assurance Co. v. American Bankshares Corp.,* CCH Fed. Sec. L. Rptr. (1977-1978 Transfer Binder) ¶ 96,274, at 92,764, 92,766 (E.D. Wisc., 1977)

   a. The functional equivalent of intent was found in Sundstrand where the defendant was cognizant of the danger of misleading the plaintiff or the danger was obvious, but nevertheless, acted recklessly or recklessly failed to act in his dealings with plaintiff. The complaint in this case alleges that the defendants knew of the plaintiff's reliance on the representations made by the defendants, or they should have known them to be such. As stated above, the Court finds the allegation of "should have known" sufficient to allow proof of reckless conduct.

(Brief author's note: These definitions together with Professor Prosser's are in part objective and in part subjective. The reason for classifying as objective is that the emphasis in the definition is on an external standard (Sundstrand) and the emphasis

on "highly unreasonable omission" (Franke).

4. Distinctions blurred

a. Ruder, D. S., *Factors Determining the Degree of Culpability Necessary for Violation of the Federal Securities Laws in Information Transmission Cases,* 32 Washington & Lee L. Rev. 571 (1975)

1. Reckless conduct exists when the defendant acts in conscious disregard of, or indifference to, the risks that others will be misled. This conduct includes what is sometimes referred to as "gross negligence."

b. Bromberg, *Securities Law: Fraud,* Sec. 8.4(572), pp. 208-209

1. Recklessness has no precise relationship to actual knowledge and constructive knowledge. Sometimes it is treated as an alternative to constructive knowledge . . . (T)he actor's possession of actual knowledge of truth or incompleteness of information will naturally enhance the probability that he will be found reckless

(and held liable) in making representations or omissions of the information.

c. *Shemtob v. Shearson, Hammill & Co.,* 448 F.2d 442, 445 (2nd Cir., 1971)

1. Thus plaintiffs' claim is nothing more than a garden variety customer's suit against a broker for breach of contract, which cannot be bootstrapped into an alleged violation of § 10(b) of the Exchange Act, or Rule 10b-5, in the absence of an allegation amounting to scienter, intent to defraud, reckless disregard for the truth, or knowing use of a device, scheme or artifice to defraud.

d. *Ernst & Ernst v. Hochfelder,* 425 U.S. 185, 194, 47 L.Ed.2d 668, 677, 96 S. Ct. 1375, 1381 at n. 12.

1. In certain areas of the law recklessness is considered to be a form of intentional conduct for purposes of imposing liability for some act.

B. Tort Law.

1. Reckless disregard for the truth
   a. Objective standard
      1. *Holmes, O., The Common Law* (1881) at 109
         a. Now what does "recklessly" mean. . . . It means only that the data for the statement were so far insufficient that a prudent man could not have made it without leading to the inference that he was indifferent. That is to say, repeating an analysis which has been gone through with before, it means that the law, applying a general objective standard, determines that, if a man makes a statement on those data, he is liable, whatever was the state of his mind, and although he individually may have been perfectly free from wickedness in making it.
      2. *Derry v. Peek*, 14 App. Cas. 337, 374 (1889)
         a. Secondly, fraud is proved when it is shown that a false representation has been made (1) knowingly, or (2) without belief in its truth, or (3) recklessly, careless whether it be true or false. . . . Although I have treated the second and third as

distinct cases, I think the third is but an instance of the second, for one who makes a statement under such circumstances can have no real belief in the truth of what he states . . . . Thirdly, if fraud be proved, the motives of the person guilty of it is immaterial. It matters not that there was no intention to cheat or injure the person to whom the statement was made.

(Brief author's note: Unlike Holmes' definition which is clearly objective, Derry v. Peek is objective for the purposes of this brief because knowing conduct has been specifically identified, and the general qualifying statement that intent to cheat does not matter. Whatever the classification of "without belief in the truth" may be, this brief assumes it is not subjective.)

2. Recklessness as to consequences
   a. Subjective standard
      1. *Restatement of Torts* (1939) § 500, at 1293-1295
         a. § 500, Reckless Disregard of Safety
            1. The actor's conduct is in reckless disregard of the safety of another if he intentionally does an act or fails to do an act which it is his duty to the other to do

knowing or having reason to know of facts which would lead a reasonable man to realize that the actor's conduct not only creates an unreasonable risk of bodily harm to the other but also involves a high degree of probability that substantial harm will result.

b. Comments to § 500

1. Comment b, Perception of risk

a. Conduct cannot be in disregard of the safety of others unless the act or breach of duty is itself intended, notwithstanding that the actor knows of facts which would lead any reasonable man to realize the extreme to which it subjects the safety of others.

2. Williams & Hepple, *Foundations of the Law of Torts* (1976)

a. If it is neither desired nor foreseen as certain, but is nevertheless foreseen as possible, and if the actor is not justified in running such a risk, the conduct is said to be reckless as to consequence.

3. Harper and James, *Law of Torts* (1956) at 533

a. But the intent to deceive is present when a defendant makes a statement which he knows to be false or which he does not know to be true, for the purpose of inducing the plaintiff to act in reliance upon the truth.

4. Keeton, P., *Fraud: The Necessary Intent to Deceive*, 5 U.C.L.A. L. Rev. 583, 592 (1958)

a. The jury can be told that if the defendant made a positive and unqualified representation as to the existence of a particular fact, and did so actually realizing that the information relied upon was inadequate and insufficient to justify a feeling of certainty about it, then they must find that the representation was fraudulently made.

b. I suggest that this is actually a much more understandable proposition than the often used formula of Derry v. Peek.

b. Objective standard

1. Prosser, *Law of Torts* (4th ed. 1971) at 185

a. The usual meaning assigned to "wilful", "wanton", or "reckless", according to taste as to the word

used, is that the actor has intentionally done an act of an unreasonable character in disregard of a risk known to him or so obvious that must be taken to have been aware of it, and so great as to make it highly probable that harm would follow. It is usually accomplished by a conscious indifference to the consequences, amounting to willingness that they shall follow; and it has been said that this is indispensable.

3. Substantially certain consequences
   a. Prosser, *Law of Torts* (4th ed. 1971) at 31-32
      1. Intent, however, is broader than a desire to bring about physical results. It must extend not only to those consequences which are desired, but also to those which the actor believes are substantially certain to follow from what he does.
      2. Apparently, the line (between intent and negligence) has been drawn by the courts at the point where the known danger ceases to be only a foreseeable risk which a reasonable man would avoid, and becomes a substantial certainty.

C. Criminal Law.

1. Gross negligence
   a. Cross and Jones, *Introduction to Criminal Law* (6th ed. 1968) at 44.
      1. Senses of recklessness
         a. "Recklessness" is used in two senses. In the first (subjective) sense, it means the conscious taking of an unjustified risk.
      2. Objective sense
         a. In the second (objective) sense "recklessness" means conduct which in fact involves an unjustified risk, whether the agent knows the risk or not.

            In its second sense, "recklessness" is the equivalent of gross negligence, . . . The risk must have been avoided by the exercise of slight care.

2. Recklessness as to circumstances
   a. Williams, *The Criminal Law* (2nd ed. 1961) at 148-149
      1. Involves knowledge of the circumstances, or of the possibility of the circumstances. It occurs where there are some circumstances, specified by law as part of the actus reus, which the actor does not positively know to be present in his own case, but which he consciously takes the risk of being present.

2. A good example is deceit or fraud. This can be committed intentionally or recklessly: intentionally where the falsity of the statement is known, recklessly where the falsity is not positively known but where the utterer does not know whether the statement is true or false. The leading authority is *Derry v. Peek* (1889).
3. The element common to the two kinds of recklessness is the conscious taking of a risk. The presence or absence of the fact (the consequence or circumstance) is not part of the actor's purpose, but he chooses to ignore the possibility of the fact in order to pursue his purpose.

3. Recklessness as to consequence
   a. Williams, *The Criminal Law* (2nd ed. 1961) at 53, 58, 62 and 63
      1. Occurs when the actor does not desire the consequence, but foresees the possibility and consciously takes the risk.
      2. Occurs where the consequence is foreseen not as morally or substantially certain but only as "probable" or "likely," or perhaps as "possible."
      3. It (recklessness) is like intention in that the consequence is foreseen, but the difference is that whereas in intention the consequence is desired, or foreseen as a certainty, in recklessness

it is foreseen as possible or probable but not desired.

4. Recklessness is a branch of the law of negligence; it is that kind of negligence where there is foresight of consequences. The concept is therefore a double barreled one, being in part subjective and in part objective. It is subjective in that one must look into the mind of the accused in order to determine whether he foresaw the consequence. If the answer is in the affirmative, that is the end of the subjective part of the enquiry and the beginning of the objective part. One must ask whether in the circumstances a reasonable man having such foresight would have proceeded with his conduct notwithstanding the risk. Only if this second question, too, is answered in the affirmative is there subjective recklessness for legal purposes. If the first requirement is negatived one may still proceed to ask the second question, but the result can only be to establish inadvertent negligence.
   a. Consequences may range in every degree from the remote and unexpected, through the reasonably possible, the likely or probable, to the inevitable.
   b. The conclusion is that knowledge of bare possibility is suf-

ficient to convict of recklessness if the conduct has no social utility, but that the slightest social utility of the conduct will introduce an enquiry into the degree of probability of harm and a balancing of this hazard against its social utility. If this is the law, it would be useless to define probability in mathematical terms, because the degree of probability that is to constitute recklessness must vary in each instance with the magnitude of the harm foreseen and the degree of utility of the conduct.

c. The subject theory of recklessness requires that the defendant should have foreseen the degree of probability of the consequence which is held to make the act reckless.

d. Thus the extent of probability of damage is a subjective question, dependent on the foresight of the accused; yet the social desirability of the risky conduct, and the question whether it balances the foreseen danger, are objective questions to be judged by the standard of the reasonable man.

e. It must be admitted that this makes the enquiry into reckless-

ness even more abstruse than it has appeared before. Degrees of possibility or probability, in the circumstances that come before the courts, are almost incommunicable, except in rough terms. Even if they were communicable, it would often be difficult to prove against a defendant the precise degree of his foresight. In practice, a defendant may find himself judged by the standard of what a reasonable man would have foreseen, even though this standard may sometimes result in the conviction of one who was not reckless in fact. The finding of recklessness is easiest where the defendant was bent upon wrongdoing, and pursued his aim regardless of an obvious risk; such a defendant can be accounted reckless because he was not entitled, for the sake of his unlawful ends, to inflict *any* foreseen risk upon others. His plea that he thought the risk a small one will not avail him, because he was not entitled to bring others even into small danger for an unlawful purpose of his own.

b. Le Fave and Scott, *Criminal Law* (1972) at 215-216

1. Recklessness vs. Intention and Knowledge
    a. We have seen that crimes defined so as to require that the defendant intentionally caused a forbidden bad result are usually interpreted to cover one who knows that his conduct is substantially certain to cause the result, whether or not he desires the result to occur. "Recklessness" in causing a result exists when one is aware that his conduct might cause the result, though it is not substantially certain to happen. . . . . (T)hus while "knowledge" and knowing-type of intent require a consciousness of almost-certainty, recklessness requires a consciousness of something far less than certainty or even probability.

c. *Model Penal Code*
    1. § 2.02(2)(c) (T.D. No. 4 p. 13)
        a. A person acts recklessly with respect to a material element of an offense when he consciously disregards a substantial and unjustifiable risk that the mental element will exist or will result from his conduct. The risk must be of such a nature and degree that, considering the nature and purpose of the actor's conduct

and the circumstances known to him, its disregard involves culpability of high degree.

4. Wilful blindness
    a. Williams, *The Criminal Law* (2nd ed., 1961) at 157-159
        1. To the requirement of actual knowledge there is one strictly limited exception. Men readily regard their suspicions as unworthy of them when it is to their advantage to do so. To meet this, the rule is that if a party has his suspicions aroused but then deliberately omits to make further inquiries, because he wishes to remain in ignorance, he is deemed to have knowledge.
        2. In other words, there is a suspicion which the defendant deliberately omits to turn into certain knowledge. This is frequently expressed by saying that he "shut his eyes" to the fact, or that he was "wilfully blind."
        3. There must have been something to put the accused on inquiry. Hence, . . ., it was held to be wrong to direct the jury that if a man is reckless and does not care, he is just as guilty as if he received the property, knowing at the time that there was something wrong with it. Recklessness and "not caring" are not quite the same thing as wilful blindness; such words express the latter doctrine too widely.

Relationship of Classification to Definition.

It is evident from the outline that the definition of recklessness in Rule 10b-5 matters is determined by whether the conduct is labeled as deceit, *i.e.*, recklessness as to circumstance/reckless disregard for the truth, or whether the conduct is labeled as other than deceit, *i.e.*, recklessness as to consequence.

The importance of *Affiliated Ute* is that the decision practically mandates all Rule 10b-5 matters to be considered as deceit cases. By funnelling all the facts through a "failure to disclose" test if the facts are not clearly deceit facts, the decision locks in the recklessness as to circumstance notion, regardless of whether the *Affiliated Ute* decision itself logically follows from the cases which purportedly underpin it.

Another consideration is whether the notion of recklessness as to circumstance applies at all in the securities fraud context. Unlike common law deceit cases, the claim for relief in Rule 10b-5 matters is based on fraud or deceit in connection with the purchase or sale of a security. Common law deceit focuses on the misrepresentation regardless of the context. Consequently, the sweep of recklessness as to circumstances is much narrower than recklessness as to consequence. A better way of putting it is that recklessness as to circumstance is recklessness as to consequence where the consequence is deceit. In Rule 10b-5 matters, the consequence prohibited is securities fraud, not merely a misrepresentation. Hence, recklessness as to consequence is a preferable general rule, and recklessness as to circumstance is not applicable regardless of its historical application in common law deceit cases.

The relationship of classification to definition is best typified by the definition of recklessness found in the *Franke* case. The fraud is classified as an "omission," and consequently recklessness is applied to reckless conduct in an omissions case. Consequently, if the "omissions" concepts are unsound, so too is the related definition of reckless conduct.

Subjective vs. Objective.

Professor Williams in *The Mental Element in Crime* (1965) at p. 57 states:

> On the issue of recklessness, the question is whether the facts speak so loudly that the jury can profess themselves satisfied beyond a reasonable doubt that the defendant must have foreseen—that they cannot imagine that he did not foresee—the possibility of the consequence.

And at 71, he states:

> On the issue of recklessness, the question is whether the accused person—the very man before the court—foresaw the consequence. The jury may consider whether the accused must have foreseen the consequence—meaning, did foresee it. It would even be permissible to consider whether the accused must as a reasonable (*i.e.*, sane) man have foreseen the consequence. But this formula needs to be understood, for it should not be confused with the question whether the accused *ought* as

> a reasonable man to have foreseen the consequence —which is a question not of recklessness but of negligence.

Professor Prosser at 31-32 states regarding extending intent to consequences which the actor believes are substantially certain to follow from what he does:

> The practical application of this principle has meant that where a reasonable man in the defendant's position would believe that a particular result was substantially certain to follow, he will be dealt with by the jury, or even by the court, as though he had intended it.

It is true the distinction is a subtle one. Professor Williams states at 57:

> Generally, the only way of establishing recklessness is to show that the consequence was so obvious that anyone with a grain of sense must have foreseen it. If the defendant was grossly negligent, we may be driven to the inference that he foresaw the risk, so it may be contended that the two questions merge.

Consequently, Professors Prosser and Williams generally agree on the subjective nature of recklessness. The difficulty observed by both is that in practice the distinction is subtle when it comes to judging the subjective element, although as Professor Williams cautions the distinctions should be preserved.

The *Sundstrand* decision illustrates another problem relative to the subjective-objective dichotomy. The *Sundstrand* definition emphasizes the objective nature of recklessness, *i.e.*, highly unreasonable omission. The Seventh Circuit equated this external standard with intent, but did not address the subjective nature of

the same definition which required knowledge of the danger of misleading or obviousness that the actor must have been aware of it. Such an oversight encourages the objective practical application suggested by Professor Prosser.

The result of *Sundstrand* was the regression back to "should have known" language under the guise of recklessness, although on its face it is clearly negligence terminology. Therefore, in this subtle as well as complex area, the importance of definition ought not to be forgotten.

Degree of Probability of Consequence.

Professor Williams and Professor Prosser differ as to the required probability of consequence required to establish recklessness. Professor Prosser requires substantial certainty. Professor Williams in The Criminal Law (2d ed. 1961) at 62 states:

> . . . (t)he degree of probability that is to constitute recklessness must vary in each instance with the magnitude of the harm foreseen and the degree of utility of the conduct.

This brief leaves this question open, but given that there are varying conceptions of recklessness, the question is relevant to any consideration of recklessness.

Conclusion.

Since *Affiliated Ute* influences the classification of securities fraud cases, it is important to ascertain whether its view is theoretically sound. This is a prerequisite to examining the question of the applicability of recklessness as a form of scienter in securities fraud law. The view of this brief is that it is not theoretically sound, unless the fictions the decisions established were intended.

If the views of *Affiliated Ute* suggested by this brief are endorsed, then the following questions relative to recklessness ought to be answered:

1. Is recklessness subjective or objective?
2. Is recklessness as to circumstance applicable to Rule 10b-5 matters?
3. Is recklessness as to consequence applicable to Rule 10b-5 matters?

This brief has suggested the following:

1. Recklessness is subjective.
2. Recklessness as to circumstance is inapplicable to Rule 10b-5 matters.
3. Recklessness as to consequence is applicable to Rule 10b-5 matters.

Respectfully submitted,

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Service of the within and receipt of a copy thereof is hereby admitted this ..... day of October, A.D. 1978.

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